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**TRANSFER PRICING OF BUSINESS  
RESTRUCTURINGS FROM THE  
PERSPECTIVE OF RUSSIAN, FINNISH AND  
U.S. TAX LAW**

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ACADEMIC DISSERTATION

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*Dedicated to Minna*



# ABSTRACT

Business restructuring generally means the cross-border restructuring of multinational enterprises' risks, functions and/or assets. In practice, it means that existing commercial relations between associated companies are reorganized within a multinational group to implement new business strategies. Although the phenomenon is not entirely new, it has become a particularly topical tax law related question only in recent years, leading to the OECD adopting Chapter IX (Transfer Pricing Aspects of Business Restructurings) to the OECD Transfer Pricing Guidelines in 2010. Nevertheless, the tax and transfer pricing treatment of business restructurings is seldom expressly regulated on a national level.

This research deals with the transfer pricing treatment of business restructurings from the perspective of Russian, Finnish and U.S. tax law. Transfer pricing can be defined as pricing of transactions that are conducted between related companies. The guiding principle of transfer pricing — the arm's length principle — requires that the pricing of a related party transaction must ultimately conform to prices used between independent parties in similar transactions under similar circumstances. The main topic of this study is further divided into two primary research questions. First, this study examines to what extent business restructurings may become objects of transfer pricing under the national transfer pricing regulations in Russia, Finland and the USA. This includes the evaluation of whether the types of assets and something of value, which are usually transferred in business restructurings between associated parties, fall within the scope of application of the national transfer pricing regulations. The second research question is how the arm's length transfer prices should be determined for transfers of such assets/something of value that are deemed to be in the scope of the national transfer pricing rules in business restructurings. Further analysis is presented in connection with the examination of both research questions regarding whether the prevailing national transfer pricing regulations follow efficiently the arm's length principle and whether the OECD Transfer Pricing Guidelines could currently be used as an international standard in transfer pricing of business restructurings that should also be adopted to domestic transfer pricing rules.

This study aims to clarify the position of business restructurings as a legal phenomenon in the set of legal norms regulating transfer pricing. This research approach is known as a legal dogmatic approach or method, where the content of existing law is interpreted and the existing legal situation

concerning a specific question (i.e. business restructurings) is clarified. As the research objective is to examine the current legal state concerning transfer pricing of business restructurings in Russia, Finland and the USA, the results derived from the aforementioned jurisdictions are compared with each other. Thus, the second research method in this study is the comparative method or approach.

This research reveals that, as a result of the narrow scope of application of the Russian transfer pricing rules and the lack of clarifying interpretations of legally binding nature, only transfers of tangible property and intellectual properties fall within the scope of the Russian transfer pricing rules in the business restructuring context. Thus transfers of other assets of commercial value as well as premature terminations or renegotiations of agreements are likely to fall outside the scope of the Russian transfer pricing rules. Furthermore, no legal support can be found for the view that contemporaneous transfers of interrelated assets and functions could be identified and valued on an aggregate basis (i.e. as a going concern). The existing situation is not in line with the approach taken by the OECD Transfer Pricing Guidelines and is troublesome especially from the perspective of the arm's length principle.

Quite the contrary, business restructurings fall more effectively within the scope of application of the national transfer pricing rules and regulations in Finland and the USA. Although certain partial issues remain ambiguous (in particular, the transfer pricing treatment of goodwill and going concern value in the USA), the assets/items-of-value that are typically transferred in business restructurings fall well within the scope of the national transfer pricing rules. This means that intangible assets transferred between related parties are also generally objects of transfer pricing (i.e. subject to the arm's length principle) had unrelated parties compensated transfers of such assets in corresponding situations. Moreover, related parties are required to examine on a case-by-case basis whether premature terminations or renegotiations of existing agreements should potentially be compensated in a business restructuring and whether the restructuring should be regarded as a transfer of a going concern and thus examined as a whole.

Consequently, the compliance with the arm's length principle is primarily required and followed effectively in business restructurings pursuant to Finnish and U.S. tax law. However, in one respect, concerns from the perspective of the arm's length principle may arise. Although intangible assets generally fall within the scope of the Finnish and U.S. transfer pricing rules, the broad concept of intangible property in transfer pricing is not entirely clear and straightforward. In consequence, the question of to what extent intangibles fall within the scope of the transfer pricing rules in business restructurings may cause interpretive problems in cases where it is not self-

evident whether certain items or assets should be regarded as intangible assets. This kind of vagueness is, in the end, against the aim of the arm's length principle.

This study also reveals that the determination of arm's length compensations for transfers of something of value occurring during a business restructuring may be challenging. This culminates especially in determining arm's length compensations for transactions that involve purely transfers of intangibles or transfers of a going concern. Although the regulated transfer pricing methods, especially profit-based methods, may be applied to transactions involving intangibles in certain cases, they may not always provide sufficient tools for determining arm's length compensations, for instance, due to that reliable comparable uncontrolled transactions cannot be found for the related party transaction in question, or that the application of the methods in a given case is otherwise troublesome. Furthermore, traditional transfer pricing methods can poorly be applied to transfers of a going concern or business units, and clarifying and detailed guidance in this respect is missing.

Nevertheless, all the target countries also allow taxpayers to use other unspecified valuation methods and techniques than specifically regulated transfer pricing methods, provided that such methods bring the most reliable arm's length results in such situations. In valuing intangibles, the income based methods are especially important, such as the discounted cash flow method, as they are commonly used in practice in the direct valuation of intangibles in transactions between independent parties, and therefore they will more likely provide a more reliable arm's length result. Similarly, the cash flow/income based methods, especially the above-mentioned discounted cash flow method and its variations, have also been widely approved and considered reliable and appropriate in determining the value for a going concern. As these kinds of valuation techniques are generally applied in practice by independent parties in the business valuation too, they will likely provide the best results in terms of the arm's length principle also in transactions between related parties.

The application of such methods to business restructurings is, however, not an easy and straightforward task, as it often involves the projection of future income streams/cash flows and the determination of an appropriate discount rate. In addition, tax authorities have not clarified how such unspecified methods should be applied specifically in the transfer pricing and/or business restructuring context. In conclusion, several uncertainty factors relate to the transfer pricing of business restructurings in Russia, Finland and the USA. It is not entirely clear in all cases, inter alia, to what extent transfers of intangible assets fall within the scope of application of the national transfer pricing regulations, what the most appropriate transfer pricing method in a given case is, and how to apply the chosen method in practice.

As the aforementioned concerns in relation to the compliance with the arm's length principle have not been addressed in the OECD Transfer Pricing Guidelines either, the guidelines cannot, in their present form, be used efficiently as the international transfer pricing standard that could be adopted to domestic transfer pricing rules to comply with the arm's length principle in business restructurings. Usually, the best solution to address the existing uncertainties is the conclusion of advance pricing agreements (APAs) with tax authorities. Once an APA has been concluded, the tax authorities must follow it. Nonetheless, the use of APAs is not uncomplicated especially in Russia, where bilateral/multilateral APAs cannot yet be concluded. As the unilateral APAs are not binding on foreign tax authorities in a similar manner as the multilateral APAs, they may not currently be used effectively in cross-border business restructurings to tackle uncertainties related to transfer pricing. On the contrary, the current legal situation in Finland and the USA enables the conclusion of both unilateral and bilateral/multilateral APAs, and therefore APAs may be used as an effective tool to eliminate at least some uncertainties and ambiguities related to the transfer pricing issues arising out of business restructurings.

In addition to APAs, the compliance with the general transfer pricing documentation and reporting requirements as well as taxpayers' self-initiated transfer pricing adjustments may lead to potential transfer pricing disputes with tax authorities being avoided. Lastly, apart from analyzing whether related parties have complied with the arm's length principle during business restructurings, the anti-avoidance rules prohibiting unjustified tax benefits must be borne in mind in the decision-making regarding business restructurings.



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Internal Revenue Bulletin 2012-12

Internal Revenue Manual

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#### *Constitutional Court*

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## **INTERVIEWS**

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# ABBREVIATIONS

AAP	<i>Laki verotusmenettelystä 18.12.1995/1558</i> (Act on Assessment Procedure of Finland)
APA	Advance pricing agreement
BEPS	Base erosion and profit shifting
CFR	Code of Federal Regulations (USA)
CUP	Comparable uncontrolled price
CUT	Comparable uncontrolled transaction
EU	European Union
EU JTPF	EU Joint Transfer Pricing Forum
Fed. Reg.	Federal Register (USA)
HE	<i>Hallituksen esitys</i> (Proposal of the Finnish government)
IFA	International Fiscal Association
IFRS	International Financial Reporting Standards
IPR	Intellectual property right
IRC	Internal Revenue Code of 1986 (USA)
IRS	Internal Revenue Service (USA)
KHO	<i>Korkein hallinto-oikeus</i> (Supreme Administrative Court of Finland)
KKO	<i>Korkein oikeus</i> (Supreme Court of Finland)
KTM	<i>Kauppa- ja teollisuusministeriö</i> (Finnish Ministry of Trade and Industry)
Minfin	<i>Ministerstvo finansov Rossijskoj Federatsii</i> (Ministry of Finance of the Russian Federation)
MNE	Multinational enterprise
OECD	Organisation for Economic Co-operation and Development
OECD Convention	Convention on the Organisation for Economic Co-operation and Development, Paris 1960
OECD Model Tax Convention	OECD Model Tax Convention on Income and on Capital
OECD Transfer Pricing Guidelines	OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations 2017
PeVL	<i>Perustuslakivaliokunnan lausunto</i> (Statement of the Finnish Committee for Constitutional Law)



R & D	Research and development
Rev. Proc.	Revenue Procedure (USA)
Tax Code	<i>Nalogovyy kodeks Rossijskoj Federatsii, chast 'Pervaya ot 31 iyulya 1998 g. N 146-FZ i chast' Vtoraya ot 5 avgusta 2000 g. N 117-FZ</i> (Russian Tax Code)
Treas. Reg.	Treasury Regulations (USA)
U.S. Code	Code of Laws of the USA
VAT	Value added tax

# 1 INTRODUCTION

## 1.1 BUSINESS RESTRUCTURING AS A PHENOMENON

The restructuring of companies' business models, *business restructuring*, generally means the cross-border restructuring of multinational enterprises' risks, functions and/or assets. In other words, it can be described as a cross-border reorganization of commercial or financial relations between associated companies.<sup>1</sup> This may mean, for example, that associated companies located in different countries allocate certain functions, assets and risks within the group of companies for the purpose of adopting the group's new business model. The definition itself is broad and may concern simple and straightforward changes as well as multidimensional and complex changes; business restructurings may also result in the closing down of a whole business unit. A universally approved or a legal definition of business restructuring does not exist.<sup>2</sup>

The business models of multinational enterprises have usually been designed to follow certain business strategies. A group of companies may aim to place its group companies in different countries due to logistical reasons, availability of factors of production and location of market.<sup>3</sup> Over the last few decades, the trend has especially been to amend the business models of group companies located in different countries by transferring parts of their functions in a controlled way to only one group company, often a parent company. In practice, this means that the companies which have been operating fairly independently in different countries, transfer parts of their tangible and intangible assets, as well as expertise used in their business activities, to a receiving group company, which locates in another country.<sup>4</sup>

Various aims may trigger business restructurings: the execution of the group's global business plan to maximize synergies, the streamlining and optimizing the administrative functions of business units as well as increasing the efficiency of the supply chains.<sup>5</sup> Synergies may be, for instance, cost synergies or functional synergies. Cost synergies relate to reducing the multinational company's expenses, which arise from business activities; one measure to achieve such synergies is to eliminate certain functions or tasks, which may be

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<sup>1</sup> Kroppen – Silva 2011, p. 20; OECD Transfer Pricing Guidelines, 9.1–9.2.

<sup>2</sup> OECD Transfer Pricing Guidelines, 9.1.

<sup>3</sup> Engblom et al. 2010, p. 545.

<sup>4</sup> Newby – Sarson – Preshaw – Cummings – Skaletsky 2008, p. 17.

<sup>5</sup> Owens 2007, p. 4.

considered duplicative within the group of companies. Functional synergies, on the other hand, may be reached by centralizing some of the group's functions (e.g. human resources) in a specific group company. The centralization helps the group to achieve savings and concentrate on providing services of better quality.<sup>6</sup>

The business restructuring of a multinational enterprise is often closely linked to supply chain management. Supply chain management can be defined as the management of the procurement and movement of raw materials within a group, the manufacturing of products of such raw materials as well as transferring of the finished products from the group to the customers. In supply chain management, the multinational group places functions, assets and risks in different countries in a way that minimizes its costs and expenses and maximizes operational efficiency. In particular, the opening of national markets, technological innovations and contractual freedom have made the transfers of functions, assets and risks from one company to another easier than ever and, at the same time, have contributed to creating new business models.<sup>7</sup> A business restructuring may relate to the improvement of the supply chain management of a multinational enterprise. For example, the enterprise may aim at fast deliveries towards customers and quantitative deliveries, and therefore amends its business models to meet such goals.<sup>8</sup>

Although the phenomenon of business restructurings is not entirely new, as it has its roots in the mid-1990s,<sup>9</sup> it has become a particularly topical tax law related question only in recent years. The OECD's Committee on Fiscal Affairs published in 2008 draft transfer pricing guidelines dealing specifically with business restructurings. Finally, in 2010 the OECD adopted a new chapter, Chapter IX (*Transfer Pricing Aspects of Business Restructurings*), to the OECD Transfer Pricing Guidelines, which was based on the said draft. The principles introduced in Chapter IX discuss issues in detail regarding the transfer pricing treatment of cross-border business restructurings. Nevertheless, the guidelines are not legally binding by nature and are primarily directed at the OECD member states.<sup>10</sup> The tax treatment of business

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<sup>6</sup> Stuffer – Hiller 2009, pp. 4–5. Many other reasons may be behind business restructurings, such as governmental requirements, availability of specialists in certain countries, post-actions of mergers and acquisitions and demands for products; see Stuffer – Hiller 2009, pp. 7–8.

<sup>7</sup> Russo 2007, p. 183.

<sup>8</sup> Stuffer – Hiller 2009, p. 6.

<sup>9</sup> Kroppen – Silva 2011, p. 20.

<sup>10</sup> See article 5 of the OECD Convention. See also e.g. Bullen 2011, pp. 33–34. Nevertheless, the possibility to regard the OECD Transfer Pricing Guidelines and the commentaries to the OECD Model Tax Convention as binding law has been discussed in the legal literature. Inter alia, it has been reviewed whether they could be considered binding customary international law. The requirements for such a

restructurings is thus, in the end, a matter of national legislators and tax authorities. As only a few countries have expressly regulated transfer pricing of business restructurings in national legislation,<sup>11</sup> these guidelines play a vital role in practice in many OECD member states.<sup>12</sup>

## 1.2 SCOPE OF THE RESEARCH AND LIMITATIONS

This research deals with the *transfer pricing treatment of business restructurings under Russian, Finnish and U.S. tax law*. Transfer pricing can be defined as pricing of business transactions which are executed between related corporate parties, in general companies within the same group of companies.<sup>13</sup> Transfer pricing legislation and the guiding transfer pricing principle — *the arm's length principle* — require that the pricing of a transaction between related parties must take the market forces into account and conform to prices used between independent parties in similar transactions. Otherwise, the profits of these companies will be adjusted by tax authorities by establishing the terms and conditions for the transaction, which could be expected in similar transactions between independent parties under similar conditions.<sup>14</sup> Hence, business restructurings are considered in this research as transactions conducted between related companies, i.e. companies within the same group of companies. This approach can be justified by transfer pricing's importance and economic significance in today's corporate life.<sup>15</sup>

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conclusion, however, have not usually been considered fulfilled, and therefore such a view has not gained wide support; see e.g. Wittendorff 2010a, pp. 123–124, Engelen 2006, p. 106, Erasmus-Koen – Douma 2007, p. 342 and Pijl 2008, p. 98.

<sup>11</sup> For example, Germany is one of the countries, which has regulated particularly transfer pricing of business restructurings in its national legislation. The provisions are included in the tax act concerning foreign transactions (Außensteuergesetz). See more about the provisions and the relationship between the provision and the OECD Transfer Pricing Guidelines in Wilmanns – Wellens – de Preter 2009, pp. 658–664. See also Menninger – Wellens 2011, pp. 233–235.

<sup>12</sup> See e.g. Kroppen – Silva 2011, p. 23. Nevertheless, the legislative approach to the taxation and transfer pricing of business restructurings varies considerably around the world. In addition, the taxation practices of national authorities in relation to business restructurings have been inconsistent; see more about tax authorities' practices in certain countries in KPMG 2011, pp. 9–27.

<sup>13</sup> Myrsky – Linnakangas 2009, p. 269; Wittendorff 2010a, p. 3.

<sup>14</sup> See e.g. OECD Transfer Pricing Guidelines, 1.1 and 1.3. When the pricing of related party transaction conforms to the arm's length principle, the prices are considered *arm's length*. The concept of transfer pricing and the arm's length principle are discussed in more detail in Chapter 2.2.1 of this research.

<sup>15</sup> Transfer pricing has been considered by multinational enterprises' tax experts as one of the most important tax issues in corporations, see e.g. Karjalainen – Raunio 2007, p. 11. It has been estimated that more than half of the world trade is carried between related companies, see e.g. preliminary works for the AAP, HE 107/2006 vp, p. 11.

The main topic of this study is divided into two primary research questions. First, this study examines *to what extent business restructurings may become objects of transfer pricing under the national transfer pricing regulations in Russia, Finland and the USA*. This research question includes the evaluation of whether the types of assets and something of value, which are frequently transferred in business restructurings between associated parties, fall within the scope of application of national transfer pricing regulations. Consequently, the so-called post-restructuring transactions, i.e. transactions that are conducted between associated companies after the execution of a business restructuring using the group's new business models, are not dealt with in this research. The second main research question is *how the arm's length transfer prices should be determined for the transfers of something of value (e.g. assets, risk and/or functions), which occur in the business restructuring context and are deemed to be in the scope of national transfer pricing rules*. This question comprises the analysis of how such transfers should be valued from the perspective of existing transfer pricing legislation and what transfer pricing and valuation methods the existing transfer pricing rules may provide in this respect. A detailed analysis of the technical application of such methods, having no legal nature, is excluded from the scope of this research.

In connection with the examination of both the aforementioned primary research questions, it is also analyzed *whether the prevailing national transfer pricing regulations follow the arm's length principle*, which should be the guiding principle in transfer pricing, *efficiently in business restructurings*. First, it is reviewed whether the existing transfer pricing rules and guidance require and enable the observance of the arm's length principle efficiently and thoroughly in business restructurings when the primary research questions are considered. Second, it is examined how to achieve the best result from the perspective of the arm's length principle in business restructurings on the basis of experiences from the target countries and what potential concerns may currently relate to the compliance with the arm's length principle.

In addition, as the OECD has published particular guidance with regard to transfer pricing of business restructurings, such guidance cannot be ignored when the aforementioned primary research questions are examined in more detail. Although the OECD Transfer Pricing Guidelines are not legally binding upon member states as such, national authorities are encouraged to follow them.<sup>16</sup> They constitute an international standard that is used by the member states in their tax treaties and domestic legislation, resulting in that they are

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<sup>16</sup> OECD Transfer Pricing Guidelines, Preface, 15–17.

also broadly followed in practice.<sup>17</sup> More importantly, they are even considered as the guiding source in interpreting the arm's length principle in some countries.<sup>18</sup> As both Finland and the USA are OECD member states, and given the practical relevance of the OECD Transfer Pricing Guidelines as the guiding source in transfer pricing, the applicable OECD guidance is reviewed and analyzed in connection with the examination of the aforesaid primary research questions. This includes the presentation of the guidance and viewpoints provided by the OECD on the discussed questions and an analysis of whether the OECD Transfer Pricing Guidelines could be applied as such in the target countries, or used in the interpretation of the domestic transfer pricing regulations. In particular, it is also analyzed *whether the OECD's approach to transfer pricing business restructurings could be used as a guiding international standard that could be adopted efficiently to domestic transfer pricing rules for the purpose of achieving the best arm's length result in business restructurings*.

From a tax law perspective, however, business restructurings not only raise questions with regard to transfer pricing and direct taxation, but as a multidimensional phenomenon they may also raise issues related to, inter alia, customs law and value added taxation.<sup>19</sup> For example, the determination of a correct value for goods in cross-border transactions is also of great relevance in customs law.<sup>20</sup> On the other hand, business restructurings may also realize several VAT issues; for instance, as a result of a business restructuring, a group company may be obliged to pay non-deductible VAT, which leads to higher costs of services or products acquired in the restructuring.<sup>21</sup> Although these questions are important and should be taken into account when a multinational enterprise is planning to amend its global business models, they are excluded from the scope of this research.<sup>22</sup>

Questions regarding permanent establishments may also arise in connection with business restructurings. For instance, when a part of a manufacturing

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<sup>17</sup> Calderón 2007, pp. 4–5; Bullen 2011, pp. 39–42.

<sup>18</sup> This is the case in Finland; see Finnish Tax Administration: Statement A177/200/2015. See also Bullen 2011, pp. 41–42.

<sup>19</sup> OECD Transfer Pricing Guidelines, 9.8; Kroppen – Silva 2011, pp. 21–22.

<sup>20</sup> See e.g. Fabio 2009, pp. 195–197. The transfer pricing value and customs value of goods is not necessarily the same, see Fabio 2009, p. 197. About the relationship between transfer pricing and customs law in general, see Bakker, Anuschka – Obuoforibo, Belema (edit.): *Transfer Pricing and Customs Valuation: Two Worlds to Tax as One*. IBFD 2009.

<sup>21</sup> See e.g. Cordova – Mitra – Newman – Reams – Shanda – Shapiro 2012, p. 59; van der Paardt – van der Tempel 2009, p. 159.

<sup>22</sup> About customs law and VAT questions in more detail, see e.g. Nordlund – Kallio – Kurkioja 2002, pp. 293–314. See also Mehtonen 2001a, p. 195; Kasatkin 2004, p. 2.

company's business activities is transferred to another group company located in a different country, the latter company may be deemed to have a permanent establishment in the former company's location country, for example, on the basis of the sale of products or other business activities performed in the former company's jurisdiction after the restructuring. The revenue of this activity may become an object of taxation at source.

The attribution of profits to permanent establishment is regulated in the OECD Model Tax Convention as its own question separate from Article 9 of the OECD Model Tax Convention, which deals with transactions between associated parties subject to transfer pricing.<sup>23</sup> Therefore, the business restructurings' possible impacts on permanent establishments or the formation thereof are not covered in this research.<sup>24</sup> Multinational enterprises cannot, nevertheless, ignore this issue since they may not achieve the potential financial savings they seek to achieve in business restructurings, if the result of the restructuring is the creation of a new permanent establishment in another country.<sup>25</sup>

Furthermore, it must be observed that the study focuses only on *cross-border* business restructurings and therefore, for example, restructuring transactions conducted only between domestic associated companies situated in Finland, Russia or the USA fall outside its scope. The term "business restructuring" used in this research thus refers to cross-border business restructurings also in cases where the word "cross-border" has been left out. In addition, the concept of business restructurings is limited to *outbound* business restructurings. This means that business restructurings are understood in this study as business restructuring arrangements, which involve outbound transfers of assets and/or something of value from a Russian, Finnish or U.S. group company to a foreign associated company. This approach can be described as an exit country perspective, while the opposite approach — entry country perspective — examines inbound transactions.<sup>26</sup> Usually the exit country perspective is of great interest to the tax authorities, as they are willing to intervene in arrangements where assets and something of value is transferred from their jurisdiction to foreign companies. The transferor is in such cases commonly entitled to a remuneration in accordance with the arm's

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<sup>23</sup> See Article 7 of the OECD Model Tax Convention.

<sup>24</sup> Similarly, the OECD Transfer Pricing Guidelines have excluded this question from Chapter IX; see OECD Transfer Pricing Guidelines, 9.7.

<sup>25</sup> See e.g. Cooper – Law 2010, pp. 249–256; Burgers 2009, pp. 145–158.

<sup>26</sup> See Kroppen – Silva 2011, pp. 32–34.

length principle. Moreover, in the legal literature the exit country perspective has been considered more topical.<sup>27</sup>

Lastly, it should be underlined that the concept of business restructuring in this research is separated from the so-called reorganizations, such as mergers, divisions and exchanges of shares. The reorganizations deviate from the aforementioned concept of business restructurings by their nature; besides, they are regulated under specific income tax provisions and may in some cases be tax neutral pursuant to applicable national tax law provisions of Russia, Finland and the USA.<sup>28</sup> Thus, they primarily fall outside the scope of this study.

### **1.3 RESEARCH OBJECTIVES, METHODS AND CHOICE OF COUNTRIES**

The objective of this research is to clarify the current legal state with regard to the transfer pricing of business restructurings under Russian, Finnish and U.S. law in the above-mentioned sense to answer the main research questions: namely, to what extent cross-border business restructurings may fall within the scope of national transfer pricing regulations, and what methods should be used in determining the arm's length transfer prices in such cases. For this purpose, this study aims to identify the legal sources and legal norms that should be taken into account in the transfer pricing of business restructurings. This means that, in particular, the national transfer pricing regulations and other sources of law containing legal norms concerning transfer pricing in Russia, Finland and the USA are reviewed.

More importantly, the objective of this research is to interpret such transfer pricing provisions in order to determine applicability thereof to business restructurings and to clarify to what extent restructurings may fall within the scope of national transfer pricing regulations, and in this way be objects of transfer pricing. Furthermore, the study aims to provide information on potential methods and other measures that could be used in the determination

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<sup>27</sup> See e.g. Kroppen – Silva 2011, p. 32; Zollo 2011, p. 757; Laaksonen 2006, pp. 429–430; De Robertis – Matthias – Damian 2006, pp. 17–22; Juusela – Tuominen 2011, pp. 315–316.

<sup>28</sup> For instance, § 52 a – 52 f of the Finnish Act on the Taxation of Business Profits and Income from Professional Activities (*Laki elinkeinotulon verottamisesta, 360/1968*) regulate tax neutral mergers, divisions, transfers of assets and exchange of shares. These arrangements do not have immediate tax consequences, but the taxation is postponed until the moment, when the assets/business in question are/is transferred further. In addition, both Russian and U.S. tax legislation have similar provisions, see e.g. Article 277 of the Russian Tax Code and Section 368 of the IRC.



of arm's length compensations for such transfers of something of value occurred in business restructurings that are considered to be within the scope of transfer pricing regulations.

The research aims to clarify the position of business restructurings as a legal phenomenon in the set of legal norms regulating transfer pricing in the aforementioned manner. The approach is known in the legal research methodology as a *legal dogmatic approach (method)*<sup>29</sup>, which is thus used as the main research method in this study. The legal dogmatic approach interprets the content of existing law and in general clarifies the existing legal situation (the interpretive task). In addition, the legal dogmatic approach systematizes, i.e. structures, the existing legal norms further. In this sense, it continues the work of the legislator (the systematization task).<sup>30</sup> In practice, the legal dogmatic approach examines in particular, what is the existing law's position on a certain problematic question at hand.<sup>31</sup> Therefore, a legal interpretation of an issue in a legal dogmatic research is made by interpreting sources of law;<sup>32</sup> in this study, this means sources containing existing legal norms on transfer pricing.

As discussed, the research objective is to examine the current legal state concerning transfer pricing of business restructurings *in Russia, Finland and the USA*. So that the results of the study may be efficiently used in decision-making in corporate life, it is of great importance to compare the results derived from the aforementioned jurisdictions with each other. This approach is defined as a *comparative approach*<sup>33</sup>, which is thus used as the second research method in this study. The comparative approach is methodologically close to the legal dogmatic approach. In the comparative approach, at least two countries' legal norms and phenomena are examined and compared to each other.<sup>34</sup> In this research, this means that the existing legal situation as to transfer pricing of business restructurings is explored and compared to each other from the perspective of Russian, Finnish and U.S. law in the above-mentioned sense.

The choices made with regard to the methods of this research — the legal dogmatic and the comparative approach — can be justified by referring to the fact that these methods are generally acceptable legal methods in Finnish tax

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<sup>29</sup> Alternatively known as doctrinal or black letter method. In Finnish *oikeusdogmaattinen* or *lainopillinen näkökulma (metodi)*.

<sup>30</sup> Aarnio 1998, pp. 989–990; Hirvonen 2011, p. 22; Myrsky 2003, pp. 277–278.

<sup>31</sup> Myrsky – Ossa 2008, pp. 27–28.

<sup>32</sup> Aarnio 1989, p. 195.

<sup>33</sup> In Finnish *oikeusvertaileva näkökulma*.

<sup>34</sup> Aarnio 1989, p. 50.

law research.<sup>35</sup> The legal dogmatic approach is the most frequently used method in tax law. The main reason for this is the need for information in the society regarding the existing law. Especially tax law and its regulations are constantly changing, and therefore in such an environment there is a demand for research aiming to clarify the current situation of existing law as to certain questions. In addition, the research tradition speaks in favor of the use of the legal dogmatic research.<sup>36</sup>

On the other hand, in recent years the importance of other approaches has also grown in tax law research, including the comparative approach. The comparative approach is useful in tax law research, for instance, in order to recognize possible problems, which may arise from the interpretation of tax legislation, on the basis of experiences in other jurisdictions.<sup>37</sup> Hence, the legal dogmatic approach accompanied by the judicial comparative perspective bring the best results in terms of clarifying transfer pricing regulations in relation to business restructurings in this research.

When the second research question — the determination of arm's length compensations for transfers of assets/items of value in business restructurings — is discussed, also methods used in scientific research in the field of economics and accounting, or those that combine legal and economics, could be considered.<sup>38</sup> However, this research question is, in the above-discussed manner, limited to the examination of how transfers of something of value occurring in business restructurings should be valued from the perspective of existing transfer pricing laws. In this context, the types of transfer pricing and valuation methods and techniques that are provided by the national transfer pricing sources and the OECD Transfer Pricing Guidelines are discussed. While this includes brief presentations of the content of such methods, the analysis has a clear legal dogmatic approach.<sup>39</sup> The detailed analysis of the application of such transfer pricing and valuation methods, comprising

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<sup>35</sup> Myrsky – Ossa 2008, p. 28.

<sup>36</sup> Myrsky 2009, pp. 60, 65; Myrsky – Ossa 2008, p. 28.

<sup>37</sup> Myrsky 2003, pp. 277; Myrsky – Ossa 2008, pp. 28–29. It must be noted that also other kinds of approaches can be applied in tax law research. Such perspectives include, inter alia, tax law history, tax policy and basic research. Furthermore, also non-judicial perspectives may be included in a tax law research, such as approaches related to economics or political science; see more in Myrsky 2003, pp. 277–284 and Myrsky – Ossa 2008, pp. 28–30.

<sup>38</sup> An example of the latter is the so-called *law and economics*, which, in short, means an economic analysis of existing law; see Timonen 1998, p. 100.

<sup>39</sup> This view has also been shared in the legal literature. Knuutinen has stated that, although economic factors should be taken into account when the legislated transfer pricing provision is interpreted and, consequently, it is reviewed whether the pricing of a related party transaction is arm's length, a legal dogmatic approach is still used in such an analysis; see Knuutinen 2014b, pp. 87–88.

technical calculations of parameters and figures related thereto, is not in the scope of this research. As the economic nature relates to the latter, no other research methods or approaches are applied in this study.

Despite the fact that this research discusses an internationally important legal phenomenon, which usually has cross-border impacts and is thus topical in many jurisdictions, the number of countries examined in the scope of this study is limited in the above-discussed manner. For the purpose of ensuring that the similarities and differences of the laws of the chosen target countries can be examined, compared and analyzed sufficiently in the study, also taking into account that the maximum number of pages of doctoral dissertations is limited, the countries subject to comparison within the scope of this research are restricted to the aforementioned three countries: Russia, Finland and the USA.

One of the main academic justifications behind the choice of the target countries to be considered is whether the chosen countries are able to provide different and opposing views on the discussed research questions, which are also of great interest and relevance.<sup>40</sup> From the scholarly point of view, Russian tax law can be regarded as an interesting country, as it has particularly new transfer pricing legislation that has not been examined broadly in international tax law research. More importantly, Russia is not an OECD member state, resulting in that, at least in the first place, its national transfer pricing rules may contain peculiarities or deviations from the OECD Transfer Pricing Guidelines. Also, one of the goals of this work is to provide information on the transfer pricing treatment of business restructurings, specifically from the point of view of Russian law, to Finnish and other Western companies operating in Russia,<sup>41</sup> which is why this jurisdiction is one of the target countries of this study. For example, the presence of Finnish companies in Russia has increased significantly in recent years,<sup>42</sup> and the Finnish companies operating in Russia are of the opinion that especially taxation is an unclear issue in Russia, which hinders business operations to the extent that the use of local consultants' help is very common.<sup>43</sup> For the sake of understanding the observations and results with regard to Russian law, the comparison between Russian law and laws of other countries is necessary.

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<sup>40</sup> See e.g. Van Hoecke 2015, p. 4.

<sup>41</sup> Especially in Russia the business restructurings have been very topical in the last few years, see e.g. Hansen 2008, pp. 65–68.

<sup>42</sup> Some Finnish companies' Russian subsidiaries have had and currently have several economically important projects especially in St. Petersburg and Moscow. See about some of the projects e.g. in Shlyamin 2008, pp. 266–273.

<sup>43</sup> KTM 2005, p. 55.

As the importance of the OECD Transfer Pricing Guidelines cannot be ignored in this study, it has academically been considered valuable to choose as one of the target countries a country that follows the transfer pricing guidance of the OECD, i.e. Finland.<sup>44</sup> As discussed, the OECD's guidance is currently a subject of great interest in transfer pricing. By choosing Finland as the second target country of this research, the OECD's sources and positions on transfer pricing issues will fall within the scope of this study. Moreover, as Finland is an EU member state, in addition to domestic transfer pricing sources of law and the OECD's guidance, also applicable sources of EU law will be in the scope of research, which may provide other interesting viewpoints in this research.<sup>45</sup>

The third jurisdiction subject to a comparative treatment in this study, the USA, is considered as one of the pioneer countries in terms of developing transfer pricing legislation and rules. It is usually on the front line when tax provisions and regulations are developed to tackle new issues in the field of international tax law. Having detailed and advanced transfer pricing regulations that seek to cover all possible scenarios in the area of transfer pricing, the USA is an interesting country for scientific research in transfer pricing. U.S. tax law has also, in general, global impacts on multinational enterprises, as usually more developed legal norms — such as transfer pricing rules — must also be followed by the enterprises willing to practice trade with U.S. group companies.<sup>46</sup> Consequently, the U.S. law perspective cannot be disregarded in this research.

It must be observed that one country that could be considered as potential target country in an international tax research that deals with the transfer pricing aspects of business restructurings is Germany. It has regulated the transfer pricing treatment of business restructurings specifically in its legislation.<sup>47</sup> Therefore, the examination of the German transfer pricing rules could provide interesting points of view on the research questions, especially when taking into account that business restructurings are less frequently

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<sup>44</sup> In practice, Finland follows the principles set out in the OECD Transfer Pricing Guidelines to a great degree, see e.g. Finnish Tax Administration: Statement A177/200/2015. This will be dealt with in the following chapters of this study.

<sup>45</sup> Furthermore, regardless of the cross-border nature of business restructurings and the research questions being in nature universal, one point of interest in an international tax law research conducted in Finland should be the domestic legislation and provisions; hence, the choice of Finnish law can also be validated from this perspective.

<sup>46</sup> See e.g. Markham 2005, pp. 4–5. In addition, the USA is also a member state of the OECD, as already mentioned.

<sup>47</sup> See supra note 11. The provisions are included in the tax act concerning foreign transactions (Außensteuergesetz).

regulated directly in national legislation. However, as discussed, the number of target countries is limited in this study on the mentioned grounds.

Also, already one of the chosen countries in this research – the USA – has comprehensive transfer pricing regulations that are similarly of academic relevance, although specific transfer pricing rules with regard to business restructurings have not (yet) been introduced. U.S. law with its common law features provides opposing and/or interesting views on the matter more likely than the German civil law based legal system.

Lastly, the U.S. transfer pricing rules are of great international interest taking into consideration the USA's role as a forerunner in transfer pricing law. Hence, despite that there could exist academically justifiable reasons to include the perspective of German law in the scope of this research, Germany has not been chosen as one of the target countries of this study.

## **1.4 REFERENCES AND PREVIOUS RESEARCH**

As previously mentioned, the sources of law form the object of the study, when the existing law is examined in relation to certain interpretive problems under a legal dogmatic approach. As this research concentrates on the transfer pricing aspects of business restructurings, the earlier mentioned international principle guiding transfer pricing – the arm's length principle – is the primary focus of this study. Hence, the national legislation and regulations concerning the arm's length principle in Russia, Finland and the USA are dealt with in this research, in particular, from the perspective of business restructurings and form the basis for the research.<sup>48</sup>

In addition, case law, preliminary works and administrative guidance are also regarded, although to a different extent, as sources of law in Russia, Finland and the USA.<sup>49</sup> Therefore, such sources of law are reviewed in this study when they are relevant to constitute interpretations of the existing legal situation in respect of transfer pricing of business restructurings. It has been also viewed appropriate to interview Russian tax practitioners in this research for the purposes of providing insights into the existing legal situation in Russia, as the current situation with respect to the research topic may be regarded there as exceptionally ambiguous.

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<sup>48</sup> The changes in the national legislation and regulations have been followed in this research until 10 July 2017.

<sup>49</sup> This is dealt with in more detail in Chapter 2 of this work.

The arm's length principle is based on Article 9 of the OECD Model Tax Convention<sup>50</sup> and has been discussed extensively in the OECD Transfer Pricing Guidelines. As both Finland and the USA are OECD member states, and taking into account that especially in Finland the OECD Transfer Pricing Guidelines are of practical relevance when the national transfer pricing regulations are interpreted,<sup>51</sup> the OECD Model Tax Convention and particularly the OECD Transfer Pricing Guidelines are also significant sources of law in this study. As discussed, the guidelines are also globally followed in practice and even considered as the guiding source in interpreting the arm's length principle,<sup>52</sup> which is why they should not be ignored also from this perspective. Furthermore, as the OECD has published guidance expressly with regard to the transfer pricing treatment of business restructurings, it is necessary to discuss Chapter IX of the OECD Transfer Pricing Guidelines as well as other OECD guidance affecting business restructurings in detail.<sup>53</sup>

The research topic can be considered particularly timely as the OECD just recently – on 10 July 2017 – published the newest edition of the OECD Transfer Pricing Guidelines. Before that, on 4 July 2016, it had published fairly new conforming amendments to Chapter IX of the OECD Transfer Pricing Guidelines<sup>54</sup> in connection with its Base Erosion and Profit Shifting Project (BEPS Project).<sup>55</sup> These amendments were introduced as a result of the final reports of the BEPS Project, which adopted several substantial amendments to principles set out in Chapters I, V, VI, VII and VIII of the OECD Transfer Pricing Guidelines dealing with, *inter alia*, comparability analysis, transfer pricing treatment of intangibles and transfer pricing documentation.<sup>56</sup> The 2017 edition of the OECD Transfer Pricing Guidelines is primarily a consolidated version of the OECD Transfer Pricing Guidelines that incorporated the conforming amendments to Chapter IX together with the aforementioned substantial amendments to other chapters of the OECD Transfer Pricing Guidelines that were first introduced by the said final reports of the BEPS Project.

Although the OECD did not revisit the actual guidance provided in Chapter IX with regard to transfer pricing of business restructurings, it considered that

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<sup>50</sup> See the OECD Model Tax Convention Commentary, p. 141.

<sup>51</sup> See e.g. Karjalainen – Raunio 2007, p. 18.

<sup>52</sup> Calderón 2007, pp. 4–5; Bullen 2011, pp. 39–42.

<sup>53</sup> The changes in the OECD Transfer Pricing Guidelines and other guidance published by the OECD have been followed in this research until 10 July 2017.

<sup>54</sup> See OECD Conforming Amendments to Chapter IX.

<sup>55</sup> See more about the OECD's BEPS Project in OECD: Action Plan on Base Erosion and Profit Shifting, OECD Publishing 2013.

<sup>56</sup> See OECD BEPS Actions 8–10; OECD BEPS Action 13.

conforming amendments to Chapter IX were necessary in order to avoid inconsistencies between the revised chapters and Chapter IX. This is mainly due to the fact that the latter contains several references to other chapters of the guidelines.<sup>57</sup> As no publications have yet been published in the legal literature with regard to business restructurings from the perspective of the OECD Transfer Pricing Guidelines in its newest form, this study provides new information in this respect.

International research on the transfer pricing aspects of business restructurings has been insufficient, which has resulted in ambiguity in business restructurings' tax treatment. In addition, as national legislation and the OECD Transfer Pricing Guidelines are constantly subject to changes, legal literature becomes outdated rapidly. One of the publications, where questions concerning transfer pricing treatment of business restructurings have been previously dealt with, is the IFA's *Cahiers de droit fiscal international: Cross-border business restructuring* (IFA, Vol. 96a, 2011). In the publication, the transfer pricing of business restructurings has been discussed from the perspective of national laws, also containing country reports from Russia, Finland and the USA. However, the chapter containing observations about the Russian transfer pricing regulations' applicability to business restructurings is predominantly outdated, as it was based on the former Russian transfer pricing legislation, rather than on the most recent transfer pricing rules.<sup>58</sup> The newest Russian transfer pricing regulations came into force on 1 January 2012 and replaced the older transfer pricing regulations for the most part.<sup>59</sup> This research aims to provide clarification on the transfer pricing treatment of business restructuring from the point of view of the latest Russian transfer pricing provisions.

On the other hand, the IFA's publication provides useful information on the existing situation in Finland and the USA, especially in terms of applying the arm's length principle to transfers of certain assets and functions during business restructurings, which may not be disregarded in this study.<sup>60</sup> However, in some respects the presented views on the applicability of the Finnish and the U.S. transfer pricing regulations to business restructurings can be considered very limited or must even be treated with caution. For instance, the branch reports fail to analyze, almost at all, the applicability of different transfer pricing methods in the business restructuring context. In addition, the relationship between the national provisions and Chapter IX of the OECD Transfer Pricing Guidelines is not discussed. Besides, as was the

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<sup>57</sup> OECD Conforming Amendments to Chapter IX, pp. 1–2.

<sup>58</sup> See Evdokimov – Konnov 2011, pp. 629–635.

<sup>59</sup> See Federal'nyj zakon ot 27.07.2010 N 227-FZ.

<sup>60</sup> See Juusela – Tuominen 2011, pp. 309–323; Zollo 2011, pp. 757–778.

case with Russia, the chapters concerning Finland and the USA contain in some parts outdated interpretations of existing law.<sup>61</sup> Finally, the IFA's publication is not by nature a legal comparative study, as the branch reports dealing with the existing situations in Russia, Finland and the USA are separated from each other and in principle form only individual chapters of the publication, except for the general report.<sup>62</sup> With reference to the above stated, this study strives to cover the highlighted issues and provide a coherent legal dogmatic and comparative analysis of business restructurings from the perspective of the existing transfer pricing regulations of Russia, Finland and the USA.

In addition to the aforementioned IFA's publication, another publication where the transfer pricing treatment of business restructurings have been reviewed from the perspective of Russian law is my own article *To What Extent Business Restructurings Fall within the Scope of Transfer Pricing Regulations in Russia?* (Intertax Vol. 43, Issue 11, 2015, pp. 742–755). The article explores the extent to which business restructurings may fall within the scope of application of the newest Russian transfer pricing regulations. The article analyzes on an asset-by-asset basis whether assets and other something of value, which are often transferred in business restructurings between related parties, fall within the scope of the national transfer pricing rules. Especially Chapter 3 of this research contains parts of this article where the existing legal situation in Russia is reviewed.<sup>63</sup>

Otherwise, the tax consequences of business restructurings in Russia have not been dealt with in Russian or English legal literature. The research topic can also be considered particularly timely because of the above discussed Russia's new transfer pricing rules. These rules can be regarded as partly unclear, and since the studies in the legal literature have just scratched the surface of the rules, an in-depth legal analysis of them is still missing.<sup>64</sup> Therefore, this study

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<sup>61</sup> For example, the U.S. branch report states that outbound transfers of goodwill and going concern value are not subject to tax and consequently do not fall within the scope of transfer pricing in business restructurings; see Zollo 2011, pp. 762, 768. However, this is not necessarily anymore the case; see Chapter 3.6.5 of this study.

<sup>62</sup> The general report provides conclusions on the transfer pricing of business restructurings on the basis of all 40 branch reports published in the publication.

<sup>63</sup> Reprinted with permission of Kluwer Law International, when applicable. However, several amendments, updates and additions have been made to the original article; in addition, the article discusses only Russian perspective, while this study deals also with the Finnish and U.S. tax law aspects. Apart from Chapter 3, also Chapters 1, 2, 4, 5 and 6 may contain small parts of the said article.

<sup>64</sup> Examples of the Russian legal research on the newest transfer pricing regulations, see e.g. Kaftannikov, A. A.: *Transfertnoe cenoobrazovanie: kommentarij izmenenij Nalogovogo kodeksa RF*. Chelyabinsk 2011; Grundel, Larisa: *Sravnitel'naya kharakteristika primeneniya metodov transfertnogo*



aims to provide a new kind of information on how business restructurings may be treated in Russia from a transfer pricing perspective. The research provides an up-to-date analysis of the newest transfer pricing regulations, covering such issues as the arm's length principle, comparability analysis, transfer pricing methods and the transfer pricing documentation requirements in general.

The Finnish legal literature has provided more perspective on the transfer pricing aspects of business restructurings in comparison with the Russian legal literature. However, the publications have usually only dealt with certain specific questions regarding transfer pricing in the business restructuring context.<sup>65</sup> Perhaps the most rewarding article, where a business restructuring has been considered as a whole, is Sami Laaksonen's *Konserniverotuksen ennakkotietoja: Liiketoimintamallin muutos ja siirtohinnoittelu* (Verotus 4/2006, pp. 428–437), where the Finnish Large Taxpayers' Office's preliminary ruling practice was analyzed regarding transfer pricing of business restructurings. It should, however, be noted that the article was published many years before the publication of Chapter IX of the OECD Transfer Pricing Guidelines. On the other hand, Merja Raunio and Elina Gerdt have discussed in their article *Liiketoimintamallin uudelleenjärjestely siirtohinnoittelun näkökulmasta* (Verotus 4/2011, pp. 420–428) the OECD Transfer Pricing Guidelines' Chapter IX, but sadly the article mainly just provides an overview of Chapter IX, and does not concentrate on its applicability to the current legal situation in Finland. In addition, Pekka Mehtonen's dissertation *Siirtohinnoittelu, tuloverotus ja konsernistrategiat* (Helsinki 2005) must be highlighted, as the publication discusses business strategies of a group of companies also from the perspective of transfer pricing. Nonetheless, transfer pricing questions for actual controlled transfers of something of value performed during the execution of business strategy amendments are not considered.

There have also been articles where certain topical issues arising out of business restructurings have been examined in a more concrete manner. For example, Reijo Knuutinen has dealt with whether controlled transactions conducted during business restructurings relating to intangibles may be

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tseoobrazovaniya v Rossii i za rubezhom. Ekhnomic Nalogi Pravo, 1/2014, pp. 114–121; and Lermontov, Yu. M.: Postatejnyj kommentarij k razdelu V.1 "Vzaimozavisimye litsa. Obshhie polozheniya o cenakh i nalogooblozhenii. Nalogovyj kontrol' v svyazi s soversheniem sdelok mezhdv vzaimozavisimymi litsami. Soglashenie o tseoobrazovanii" Chasti pervoj nalogovogo kodeksa Rossijskoj Federatsii. ConsultantPlus 2011. The new rules have also been discussed in some English commentaries, see e.g. Hellevig, Jon – Usov, Artem – Kabakov, Anton: Awara Russian Tax Guide. Awara Group 2014, pp. 213–243.

<sup>65</sup> Except for the earlier mentioned IFA's publication containing a Finnish branch report.

recharacterized on the basis of the transfer pricing regulations.<sup>66</sup> Linnanvirta and Leppänen have, on the other hand, discussed the tax effects of dissolutions of companies and certain dividend questions, particularly in the business restructuring context, by comparing national income tax legislation to the OECD Transfer Pricing Guidelines.<sup>67</sup> Nordlund, Kallio and Kurkioja have discussed different kinds of business models of a group of companies from the perspective of transfer pricing, VAT and customs law, but the observations on transfer pricing are largely outdated as the article was published already in 2002.<sup>68</sup> In addition, articles concerning transfer pricing of intangibles, such as trademarks,<sup>69</sup> provide useful insights in this study due to the fact that business restructurings commonly involve controlled transfers of intangibles within the group.

In the U.S. legal literature, apart from the above-mentioned IFA's publication, there are also other publications which have dealt with the transfer pricing aspects of business restructurings at least to some extent. *Transfer pricing and business restructurings: Streamlining all the way* (IBFD 2009, edited by Anuschka Bakker) contains a chapter where the research topic is examined from the perspective of the U.S. transfer pricing regulations.<sup>70</sup> The chapter offers a view of the application of the arm's length principle to business restructurings at that time. Therefore, while it contains a lot of useful information, some of the observations are based on regulations in force in 2009. Furthermore, while the chapter covers many interesting questions in relation to the transfer pricing treatment of business restructurings — such as the treatment of the business restructuring expenses, permanent establishment questions and post-restructuring issues — it provides very little information about to what extent business restructuring could fall within the

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<sup>66</sup> See Knuutinen, Reijo: Liiketoiminnan kansainväliset uudelleenjärjestelyt, aineeton omaisuus ja verotus: transaktion tunnistamista vai uudelleenluonnehdintaa? Defensor Legis 6/2015, pp. 1054–1068. Knuutinen has also studied intangible asset transfers in business restructurings from the point of view of taxation policy, see Knuutinen, Reijo: Aineeton omaisuus, liiketoiminnan uudelleenjärjestely ja verotus: veropoliittisia tarkastelukulmia. Verotus 1/2016, pp. 5–20.

<sup>67</sup> Linnanvirta, Reima – Leppänen, Hannu-Tapani: Liiketoiminnan uudelleenjärjestelyt EVL:n ja OECD:n siirtohinnoitteluohjeiden valossa. Verotus 2/2011, pp. 201–207.

<sup>68</sup> Nordlund, Marika – Kallio, Mika – Kurkioja, Kari: Kansainvälisen konsernin liiketoimintamalli siirtohinnoittelun, arvonlisäverotuksen ja tullikysymysten näkökulmasta. Verotus 3/2002, pp. 293–314.

<sup>69</sup> See e.g. Pankakoski, Katriina: Tavaramerkin arvonmäärittäminen siirtohinnoittelussa. Verotus 3/2015, pp. 283–295; and Linnanvirta, Reima – Rapo, Petteri: Aineettoman omaisuuden tunnistamisesta ja arvostamisesta siirtohinnoittelussa. Verotus 3/2012, pp. 272–279.

<sup>70</sup> See Amerkhail – Granwell 2009, pp. 399–448. The book also provides in its other chapters useful information, inter alia, on business models and business restructurings in general as well as on permanent establishment and VAT aspects of business restructurings, see Stuffer – Hiller 2009, pp. 3–12; Burgers 2009 pp. 145–158; van der Paardt – van der Tempel 2009, pp. 159–176.

scope of application of the U.S. transfer pricing regulations. In addition, possible methods for determining arm's length compensations in the business restructuring context have been mainly left outside the scope of the content presented.

The tax treatment of business restructurings has also been discussed to some extent in certain articles. MacGregor, for instance, has dealt with some general transfer pricing questions in the business restructuring context, but as the article is only two pages long, it just scratches the surface of the topic.<sup>71</sup> On the other hand, Cordova, Mitra, Newman, Reams, Shanda and Shapiro have discussed business restructurings in their article in a more comprehensive manner, especially from the point of view of intellectual property. As the article also contains transfer pricing considerations, it provides useful views when the role of intangible assets is examined in business restructurings.<sup>72</sup> Another interesting article is Wright's and Keates' *Comments on the OECD Discussion Draft on Transfer Pricing Aspects of Business Restructurings* (International Transfer Pricing Journal, March/April 2009, pp. 115–122), where the discussion draft of Chapter IX of the OECD Transfer Pricing Guidelines was evaluated and compared to the U.S. transfer pricing regulations in force at that time.<sup>73</sup>

In the U.S. legal literature, supply chain management has also been an object of tax law research. As business restructuring are related to supply chain management in the aforesaid manner, articles dealing with the tax effects of supply chain management must be observed.<sup>74</sup> Lastly, transfer pricing aspects of certain assets, particularly intangible assets, have been of great interest in the U.S. tax and transfer pricing law literature. For example, Wittendorff has reviewed transfer pricing methods and other valuations methods suitable for controlled transfers of intangible property in the article *Valuation of intangibles under income-based methods – part I* (International Transfer Pricing Journal, September/October 2010, pp. 323–335.). Such articles

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<sup>71</sup> MacGregor, Enrique: United States. An Analysis of Transfer Pricing Issues in US Business Restructurings. Transfer Pricing International Journal, Vol. 15, No. 9, September 2014, pp. 2–3.

<sup>72</sup> Cordova, David – Mitra, Arin – Newman, Andrew – Reams, Keith – Shanda, Larry – Shapiro, Alan: Business restructuring and the role of intellectual property. International Tax Review, January 2012, pp. 47–59.

<sup>73</sup> Levey, Gerdes and Mansfield have discussed in a similar manner to the relationship between the current U.S. transfer pricing rules and the OECD's new transfer pricing guidance introduced as a result of the BEPS Project, see Levey, Marc M. – Gerdes, Imke – Mansfield, Aliss: The Key BEPS Action Items Causing Discussion in the United States. Intertax, Vol. 44, Issue 5, 2016, pp. 399–405.

<sup>74</sup> See e.g. Irving, Dan – Kilponen, Gary – Markarian, Raffi – Klitgaard, Mark: A tax-aligned approach to SCM. Supply Chain Management Review, April 2005, pp. 57–61; Wright, Deloris: United States: Supply chain management. International Transfer Pricing Journal, July/August 2006, pp. 202–207.

cannot be disregarded in this study, as usually intangibles have a pivotal role in business restructurings.

This research seeks to offer a view of the current application of the existing transfer pricing regulations in Russia, Finland and the USA to cross-border business restructurings, which have not yet been studied in a comprehensive manner from a legal dogmatic and comparative perspective. As Finland and the USA are also member states of the OECD, the study provides information on the applicability of the latest OECD Transfer Pricing Guidelines to business restructurings, which have not been studied in the legal literature either.

## **1.5 STRUCTURE OF STUDY**

The first chapter of this research defines the concept of business restructuring and presents the research questions. The study's objectives and methodology, in addition to the main references and previous legal research on business restructurings in the field of transfer pricing and tax law in general, are discussed.

Chapter 2 of this study examines the transfer pricing regulations in Russia, Finland and the USA. First, it offers an introduction to Russian, Finnish and U.S. tax law by exploring such general issues as prevailing tax legislation, the position of case law and the structure of tax administration. Subsequently, the subject of the review is the national regulation of the arm's length principle and transfer pricing in the target countries. This comprises the examination of the national sources of law regulating transfer pricing and the main transfer pricing provisions regulated therein. Such an examination also provides the basis for the review of the research questions in more detail in the following chapters.

The third chapter discusses in detail the first research question, i.e. to what extent business restructurings may fall within the scope of application of the national transfer pricing regulations. At first, different examples of amending multinational enterprises' business models are dealt with in order to demonstrate what kinds of assets may be transferred in cross-border business restructurings from one jurisdiction to another. After exploring such examples, it will be reviewed whether a business restructuring, which involves a transfer of a functioning business unit (going concern), may become an object of transfer pricing on an aggregate basis pursuant to the Russian, Finnish and U.S. transfer pricing provisions. This will be followed by an analysis of whether — and to what extent — transfers of tangible assets, intangible property and risks as well as premature terminations or renegotiations of existing agreements may become objects of transfer pricing separately. Especially transfers of intangible assets are examined thoroughly,

as there has been a great amount of interest and discussion in this regard in recent years.<sup>75</sup> The choice to discuss the applicability of the transfer pricing rules to the mentioned transfers of something of value, that could hence be regarded as objects of transfer pricing in business restructurings, is largely based on Chapter IX of the OECD Transfer Pricing Guidelines and the discussed topics therein.

Chapter 4 of the research discusses the second main research question, i.e. the determination of the arm's length compensation for such subjects of something of value, which fall within the scope of transfer pricing regulations in accordance with the national transfer pricing regulations. The comparability analysis, applicable transfer pricing methods and other valuation techniques, as well as the arm's length range, are dealt with from the perspective of the target countries.

The fifth chapter examines certain means of eliminating uncertainty factors relating to transfer pricing of business restructuring, since wrongly carried transfer pricing may cause transfer pricing adjustments and even penalties. In this respect, advance pricing agreements, transfer pricing documentation and reporting requirements, voluntary self-initiated adjustments of transfer prices and the compliance with general anti-avoidance rules are explored. Finally, Chapter 6 summarizes the observations made in the previous chapters and provides reasoned conclusions on the research.

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<sup>75</sup> For instance, the OECD's BEPS Project, more specifically Actions 8–10, published revised guidance regarding transfer pricing of intangibles as a result of this discussion; see OECD BEPS Actions 8–10.

## 2 TRANSFER PRICING REGULATIONS

### 2.1 INTRODUCTION TO TAX LAW IN RUSSIA, FINLAND AND THE USA

#### 2.1.1 TAX LEGISLATION AND TAX TREATIES

Pursuant to Article 75 of the Constitution of the Russian Federation (*Konstitutsiya Rossijskoj Federatsii*, 12 December 1993), the tax system and the general principles regarding taxation and tax collection must be regulated under federal acts.<sup>76</sup> At present, the Russian tax legislation is mainly compiled into one comprehensive code — the Tax Code (*Nalogovyj kodeks Rossijskoj Federatsii, chast' Pervaya ot 31 iyulya 1998 g. N 146-FZ i chast' Vtoraya ot 5 avgusta 2000 g. N 117-FZ*).<sup>77</sup> The Tax Code has two parts and is a result of an extensive tax reform, which stems from the years 1996 – 1997, when the Russian Ministry of Finance (*Ministerstvo finansov Rossijskoj Federatsii*, hereinafter referred to as the Minfin) presented to the State Duma a large number of proposals for amendments in the Russian tax legislation. The first part of the Tax Code came into force on 1 January 1999 and the second part on 1 January 2001.<sup>78</sup> The Tax Code holds the leading position in the hierarchy of legal sources relating to Russian tax law.<sup>79</sup>

The first part of the Tax Code includes, among other things, the definitions of the key concepts of taxation, a list of taxes levied in Russia as well as the provisions of, inter alia, the relationship between taxpayers and the tax authority, the notification obligations, the implementation of taxation as well as tax law violations, penalties and appeals related thereto. The second part of the Tax Code comprises detailed provisions in relation to specific taxes — such as VAT, excise tax and income tax — as well as provisions concerning particular tax procedures. The study's main focus is on the transfer pricing rules, which are primarily situated in the first part of the Tax Code.

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<sup>76</sup> The Constitution of Russia can be found as an official publication at <http://constitution.kremlin.ru/constitution.pdf>.

<sup>77</sup> The prevailing version of the Tax Code can be found in the Russian language, for example, at <http://base.garant.ru/10900200/>.

<sup>78</sup> Penttiä – Suhonen – Heino – Matilainen 2003, pp. 11–13. The aim of the reform has been, inter alia, the reduction of companies' tax burden, the increase of the predictability of taxation, to boost the attraction for foreign investments in Russia and generally strengthen the position of taxpayers, see Karhu 2007, p. 29. It has been considered that the state's attempt to manage natural resources had also an impact on the tax reform; see about this Bosquet 2002, pp. 34–39.

<sup>79</sup> Krokhina 2011, p. 66.

Taxes must also be regulated by acts in Finland. According to § 81 of the Constitution of Finland (*Suomen perustuslaki*, 731/1999), a state tax is governed by an act which must include provisions concerning the grounds for tax liability and the amount of the tax as well as provisions regarding legal remedies available to taxpayers. Unlike in Russia, the Finnish tax legislation is divided into several specific acts. The most important acts include, inter alia, the Income Tax Act (*Tuloverolaki*, 1535/1992), the Act on the Taxation of Business Profits and Income from Professional Activities (*Laki elinkeinotulon verottamisesta*, 360/1968), the Act on the Taxation of Farm Income (*Maatilatalouden tuloverolaki*, 543/1967), the Act on Municipal Tax on Real Property (*Kiinteistöverolaki*, 654/1992), the Value-added Tax Act (*Arvonlisäverolaki*, 1501/1993), the Prepayment Act (*Ennakkoperintälaki*, 1118/1996) and the Inheritance and Gift Tax Act (*Perintö- ja lahjaverolaki*, 378/1940).<sup>80</sup>

It must be noted that general provisions in relation to, inter alia, tax return, tax procedures, tax assessment as well as appeal are regulated in the Act on Assessment Procedure (*Verotusmenettelystä annettu laki*, 1558/1995, hereinafter referred to as the AAP). Most importantly, transfer pricing is regulated under § 31 of the AAP.

Similar to Russian and Finnish law, the legal basis for U.S. tax legislation can be found in the Constitution of the United States of America (as amended).<sup>81</sup> Pursuant to Article I, Section 8 of the Constitution, “the Congress shall have Power To lay and collect Taxes, Duties, Imposts and Excises, to pay the Debts and provide for the common Defence and general Welfare of the United States; but all Duties, Imposts and Excises shall be uniform throughout the United States.” In addition, the 16th Amendment to the Constitution states that “the Congress shall have power to lay and collect taxes on incomes, from whatever source derived, without apportionment among the several States, and without regard to any census or enumeration.”

Given the above information, the U.S. Congress has, for the purposes mentioned in the Constitution, enacted several acts which deal with questions in relation to taxation. The most important tax act is the Internal Revenue

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<sup>80</sup> See more about the taxation and tax system in Finland in Niskakangas, Heikki: *Johdatus Suomen verojärjestelmään*. Talentum 2014. The Ministry of Finance of Finland has also published a guide as regards Finnish taxation in English, see *Taxation in Finland 2009*. Ministry of Finance publications, 7/2009.

<sup>81</sup> The ratification of the actual Constitution was completed on 21 June 1788. Later, there have been 27 amendments to the Constitution, which have been ratified. See more about the amendments in Rodgers 2011, p. 110.

Code of 1986 (hereinafter referred to as the IRC). The IRC has been published as separate chapter or code — Title 26 — in the Code of Laws of the United States of America (hereinafter referred to as the U.S. Code), which compiles federal statutes of the USA.<sup>82</sup>

The IRC collectively regulates different kinds of taxes, such as income taxes, estate and gift taxes, employment taxes and excise taxes. In addition, the IRC has overall regulations in relation to tax returns, tax administration and tax assessment. Transfer pricing is also regulated in the IRC, the most important relevant provision being Section 482.

There can be seen similarities in the Russian and U.S. tax legislation as in both countries tax regulations have been codified into a legal code to a great extent. This approach differs from the approach taken in Finland, where tax legislation is divided into several separate tax acts. It should also be observed that the preliminary works of the above-mentioned Finnish tax acts usually provide interpretations or clarifications of the legislated provisions, and they are even legally binding to some extent.<sup>83</sup> This is not the case in Russia nor the USA.<sup>84</sup>

It should be mentioned that, in addition to the national tax legislation, tax provisions affecting taxation in the mentioned countries can also be found from international sources of law. Tax treaties have traditionally been of great importance in ensuring the states' rights to levy taxes and preventing the double taxation between the states. Consequently, Russia, Finland and the USA have all concluded a large amount of tax treaties with other countries, and usually these treaties have a straight impact on the taxation in the jurisdictions of the contracting parties.<sup>85</sup> In general, the OECD Model Tax Convention has a significant influence on tax treaties; for instance, the majority of the articles of tax treaties concluded by Finland follow the OECD

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<sup>82</sup> Moreover, the IRC has also been published in the *United States Statutes at Large* as Internal Revenue Code of 1986. This version and the version codified into the U.S. Code are in principle identical.

<sup>83</sup> See e.g. Aarnio 1989, pp. 220–221 and Koskinen – Virta 1996, p. 1.

<sup>84</sup> See e.g. Orlov 2010, p. 17 and Sawyers – Raabe – Whittenburg – Gill 2015, p. 150.

<sup>85</sup> For instance, alone Russia has concluded circa 50 tax treaties for the purposes of preventing double taxation, see Perov – Tolkushkin 2005, p. 104. The tax treaties take precedent over national provisions in Finland, if the tax treaties do not increase the tax liabilities of taxpayers, see e.g. Mysky – Linnakangas 2011, pp. 88–90. Tax treaties have a similar priority also under Russian tax law; see Article 7 of the Tax Code and Article 15 of the Constitution of the Russian Federation. This is not necessarily the case in the USA, where U.S. law may 'override' tax treaties, see e.g. Avi-Yonah 2006, pp. 65–79. On the other hand, usually provisions adopted later in time override the provision under the other source of law, see Sawyers – Raabe – Whittenburg – Gill 2015, pp. 90–91.



Model Tax Convention's articles.<sup>86</sup> However, tax treaties to which Russia is a party differ in this respect as the majority of the provisions of these tax treaties may not completely correspond to the provisions of the OECD Model Tax Convention, although similarities can also usually be found.<sup>87</sup> On the other hand, the USA has its own model tax convention, the U.S. Treasury Department's U.S. Model Income Tax Convention, which is generally the starting point for drafting the tax treaties to which the USA is a party.<sup>88</sup> Overall, tax treaties and the mentioned model tax conventions are important sources of law and therefore should be taken into account, especially in cross-border situations involving two or more countries.

It should also be noted that, as an EU member state, Finland has an obligation to follow legal norms regulated in the EU treaties and other sources of EU law; some of which may regulate tax questions, which have not been regulated in the national tax legislation at all.<sup>89</sup>

## **2.1.2 OTHER LEGISLATION HAVING IMPACT ON TAXATION**

When making decisions with regard to taxation in a foreign state, in addition to the general tax provisions, one must take into consideration other possible legal norms that are not necessarily regulated in specific tax acts but may nevertheless have a direct or indirect effect on tax issues of a multinational group. Therefore, this chapter deals briefly with certain acts of civil, criminal, company and private international law, which are or may closely be linked to taxation and which may hence have an impact, at least remotely, on business restructurings from a tax law perspective. The sole purpose is to raise examples of other legislation, which may be useful to take into consideration when decisions in relation to transfer pricing or taxation are made in the business restructuring context, not to provide an all-embracing analysis of such acts or provisions.

First of all, pursuant to Articles 11 and 19 of the Tax Code, the terminology, concepts and institutions of Russian civil law used in the provisions of Russian Tax Code must, in principle, be understood similarly as in the Russian civil law

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<sup>86</sup> Mehtonen 2001b, p. 43; Karjalainen – Raunio 2007, p. 18.

<sup>87</sup> Guglyuvatyy 2011, p. 340.

<sup>88</sup> See e.g. Avi-Yonah – Tittle 2007, pp. 224–234.

<sup>89</sup> The Treaty on the Functioning of the EU (TFEU) has articles regarding taxation, e.g. indirect taxation and co-operation in tax matters, see Articles 113–115. The EU treaties may also have an indirect effect on the EU member states and their tax legislation, see in more detail e.g. Helminen 2012, pp. 30–31. When there a conflict exists between national and EU law, the latter prevails over the former; see Ojanen 2007, p. 31.

legislation. The legal norms relating to Russian civil law are, as was the case with the tax law provisions, codified into one collection of provisions: the Civil Code of the Russian Federation (*Grazhdanskij kodeks Rossijskoj Federatsii*<sup>90</sup>). Thus, when the Tax Code's provisions are applied in practice, on some occasions the provisions of the Civil Code must also be taken into account in the aforementioned manner.

This is not entirely the case in Finland. As it was stated above, the Finnish tax legislation is divided into several acts. These acts contain generally specific chapters, which define the terms and concepts used in the act in question.<sup>91</sup> Therefore, without a particular reference to terms and concepts defined in other acts, there is usually no need to examine definitions regulated in other acts while applying provisions of a certain tax act. On the other hand, the situation in the USA deviates to some extent from both approaches. While § 7701 of the IRC contains an extensive list of definitions used in the application of the provisions of the IRC, some of the definitions have references to definitions regulated in other acts.<sup>92</sup> The list does not, nonetheless, have a general reference to the terms and concepts used in civil law, perhaps because of the fact that the civil legislation is not, generally, contrary to the situation in Russia, codified into one code in the USA.

In general, tax liability can be either criminal or administrative liability (also called civil liability or penalty). Criminal liability in Russia is governed by Articles 198 and 199 of the Russian Criminal Code (*Ugolovnyj kodeks Rossijskoj Federatsii, ot 13.06.1996 N 63-FZ*), which deal with criminal sanctions for tax offences. The provisions correspond to the tax fraud provisions regulated in Chapter 29 the Finnish Criminal Code (*Rikoslaki, 19.12.1889/39*) to the following extent: the tax crimes regulated by the Russian Criminal Code will become applicable only when a taxpayer has failed to pay to tax authorities a certain, quite large amount specified in the Russian Criminal Code, while the applicability of the Finnish tax fraud provision does not require a certain monetary amount. In addition, the threshold for considering something as a tax fraud is lower in Finland than the threshold for tax offence in Russia, as an attempt at tax fraud is comparable to an actual act in Finland, whereas in Russia an attempt is not a criminal offense and remains unpunished. It is also noteworthy that, unlike in Finland, a person performing acts regarded as a criminal tax offence in Russia is considered to be a person

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<sup>90</sup> Chast' pervaya ot 30 noyabrya 1994 g. N 51-F3, chast' vtoraya ot 26 yanvarya 1996 g. N 14-FZ, chast' tret'ya ot 26 noyabrya 2001 g. N 146-FZ, chast' chetvertaya ot 18 dekabrya 2006 g. N 230-FZ.

<sup>91</sup> See e.g. Chapter 2 of the Income Tax Act.

<sup>92</sup> The IRC contains also other lists of definitions, see e.g. § 6664 of the IRC.

who *formally* has performed the acts instead of the person who performed the acts *de facto*.<sup>93</sup>

Minor omissions, violations and neglects, which fall outside the scope of provisions regarding criminal tax offence, are regulated in the Tax Code and the Code of Administrative Offences of Russia (*Kodeks Rossijskoj Federatsii ob administrativnykh pravonarusheniyakh Nos 30 dekabrya 2001 g. N 195-FZ*). The codes regulate, inter alia, the fines issued in situations where a taxpayer has neglected to provide requested information for tax control purposes on time<sup>94</sup> or when taxes have not been fully or partially paid<sup>95</sup>. These consequences resulting from administrative liability are to a major extent equivalent to the punitive tax increase consequence in Finland regulated under § 32 of the AAP. These administrative sanctions shall be considered as alternatives for criminal sanctions in both Russia and Finland. Thus, the principle of *ne bis in idem* is existent in both countries, when potential tax consequences are determined. However, this has not been the case in Finland until recent years.<sup>96</sup>

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<sup>93</sup> Koistinen 2012, p. 356. See also Volzhenkin 2007, p. 708. In addition to accountants, inter alia, managers, whose duties include taking care of the full payment of a company's taxes, may be considered to be guilty of tax offence in Russia. This should be borne in mind, for instance, when the management of a consolidated enterprise makes decision with regard to transfer pricing strategies. The Russian Supreme Court's plenary session has also defined persons, who may become responsible in this respect, see Postanovlenie Plenuma Verhovnogo suda Rossijskoj Federacii ot 28 dekabrya 2006 g. N 64 "O praktike primeneniya sudami ugolovnogo zakonodatel'stva ob otvetstvennosti za nalogovye prestupleniya". About extending the liability to the CEO of a company, see the Supreme Court's decision Opreделение Verhovnogo suda Rossijskoj Federacii N 5-Do5-299 ot 27.4.2006. Sudebnaja kolegija po ugovnym delam, nadzor."

<sup>94</sup> Article 119 of the Tax Code; Article 15.5 of the Code of Administrative Offences of Russia.

<sup>95</sup> Article 122 of the Tax Code.

<sup>96</sup> Koistinen 2012, pp. 369–370. Pursuant to the previously established legal praxis in Finland, punitive tax increase decisions have not prevented from separate criminal proceedings. However, the Supreme Court of Finland changed this legal praxis so that the commencement of a criminal proceeding would not be longer possible after a tax increase decision has become final in relation to the same matter, see e.g. KKO 2010:45, 2010:46 and 2010:82. Nowadays, the relationship between the administrative and criminal sanctions in cases where punitive tax increase is or could be applied has been defined in a more precise way in the Supreme Court's decision KKO 2013:59 and Act on Surtaxes And Increased Customs Duties Imposed by a Separate Decision (*Laki erillisellä päätöksellä määrättävästä veron- tai tullinkorotuksesta*, 781/2013). According to the decision and the act, even criminal investigation cannot be conducted anymore if a decision has been made in the tax procedure on whether or not to impose a tax increase. See also the statements by the Finnish Committee for Constitutional Law, PeVL 9/2012 and PeVL 12/2013 vp.

The mentioned provisions relating to tax liability in Russia and Finland are thus at least partly regulated elsewhere than in the actual tax legislation. In this regard, the current legal situation in the USA differs from the situation in Russia and Finland. Apart from the earlier mentioned general tax questions, the main source of U.S. tax legislation — the IRC — also regulates tax liabilities and sanctions related thereto. The civil tax liability is regulated in Chapter 68 of the IRC and the criminal liability in Chapter 75 of the IRC, and therefore primarily there is no need to examine other possible legislative acts for the purpose of assessing liabilities regarding taxation. The comparison between the provisions of the IRC and the Russian and Finnish tax liability provisions is troublesome as the IRC's legal norms in this respect are much more detailed, and violations of tax law may result in a wide range of different kinds of penalties. The IRC regulates over 200 civil penalties alone.<sup>97</sup> However, similar penalty types can also be seen in the IRC. For example, it recognizes *an addition to the tax*<sup>98</sup> as one type of civil penalty and *fraud*<sup>99</sup> as one form of a criminal offense. On the other hand, at least one major difference can also be found between the tax liability regulations of the target countries. The concurrent application of both administrative and criminal liability provisions was impossible in Finland and Russia, mainly due to the principle of *ne bis in idem*. The IRC's civil and criminal liability provisions, on the contrary, may under certain circumstances be applied to the same breach of law causing both criminal and administrative penalties. The U.S. equivalent of the *ne bis in idem* principle, the so-called *double jeopardy clause*,<sup>100</sup> allows in principle conviction of both criminal and administrative sanctions for the same breach.<sup>101</sup>

When examining tax aspects of business activities, it may be useful or even necessary to also take into consideration certain provisions of corporate law. Especially the decision-making with regard to business restructurings usually also involves the examination of questions regarding company law and

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<sup>97</sup> The penalties can be categorized into different categories, see e.g. Marvel 1988, pp. 2–3. The criminal penalties have been traditionally applied in the courts only on rare occasions, see Holmes 1992, p. 1436.

<sup>98</sup> See § 6651 of the IRC.

<sup>99</sup> See § 7206 of the IRC.

<sup>100</sup> The double jeopardy clause is regulated in the Fifth Amendment to the Constitution of the USA, pursuant to which “--- [N]or shall any person be subject for the same offence to be twice put in jeopardy of life or limb ---.”

<sup>101</sup> See *Hudson v. United States*, 118 S. Ct. 488 (1997) and Watson 2016, pp. 371–372. See also Section 9.5.13 (“Civil Considerations”) of the Internal Revenue Manual. According to Section 9.5.13.2 of the Internal Revenue Manual, “both civil and criminal sanctions may be imposed for the same offense.” See also Section 4.10.6.8.1, according to which “a criminal conviction for tax evasion (under Section 7201) usually conclusively establishes liability for the civil fraud penalty.” See about the criticism regarding the relationship between civil and criminal tax fraud provisions in Ise 1971, pp. 1176–1199.

accounting, which may in turn also affect tax considerations. In Russia, the general provisions of corporate law are regulated under the Civil Code<sup>102</sup>, and thus the Civil Code is also an important source of law in this respect. Other relevant acts include, inter alia, the Federal Act on Limited Liability Companies (*Federal'nyj zakon ob obshhestvakh s ogranichennoj otvetstvennost'yu*" (ob OOO) ot 08.02.1998 n 14-FZ) and the Federal Act on Accounting (*Federal'nyj zakon ot 06.12.2011 N 402-FZ "O bukhgalterskom uchete"*). In Finland, amongst the most important acts in this field are the Limited Liability Companies Act (*Osakeyhtiölaki, 624/2006*), the Accounting Act (*Kirjanpitolaki, 1336/1997*) and the Accounting Ordinance (*Kirjanpitoasetus, 1339/1997*). There are no general federal acts in relation to corporate matters in the USA, and therefore corporate questions are primarily regulated by the states. The most used state act in this regard is the Delaware General Corporation Law.<sup>103</sup> In terms of accounting provisions, the most important source is the Generally Accepted Accounting Principles (U.S. GAAP) issued by the Financial Accounting Standards Board (FASB).

### 2.1.3 CASE LAW

The interpretation of Russian law and overall judicial discretion and the application of law in Russia are in principle based only on its legislation's legal norms. Case law and legal theory are not traditionally considered as sources of law, in contrast to, for instance, Finnish law. Nevertheless, the highest courts have achieved a strengthened position in recent years, and the decisions of the Supreme Court (*Verkhovnyj Sud Rossijskoj Federatsii*) and the Supreme Commercial Court (*Vysshij Arbitrazhnyj Sud Rossijskoj Federatsii*) have been taken into account in the legal practice of lower courts; a certain degree of binding force and frequency has also been characteristic for them.<sup>104</sup> The highest courts have the power to act as the last appellate instance, harmonize the legal practice of the courts under their supervision and provide clarifications with regard to the interpretation of legal norms. In particular, the decisions of the plenary sessions and the presidiums of these courts may often contain guidance on the application and interpretation of particular legal provisions, which lower courts are obliged to take into consideration in their decision-making.<sup>105</sup>

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<sup>102</sup> See especially Part 1 of the Civil Code.

<sup>103</sup> Title 8, Chapter 1 of the Delaware Code. More than half of the Fortune 500 companies are incorporated in Delaware, see Black Jr 2007, p. 1.

<sup>104</sup> Orlov 2010, p. 17. See also Neshataeva 2004, pp. 66–67 and Marchenko 2008, pp. 385–403.

<sup>105</sup> See Article 126 of the Constitution of Russia; Articles 2, 5 and 7 of the Act on Russian Supreme Court (*Federal'nyj konstitutsionnyj zakon ot 05.02.2014 N 3-FKZ (red. ot 04.11.2014) "O Verkhovnom Sude Rossijskoj Federatsii"*) and already repealed Articles 9–16 of the Act on Commercial Courts of Russian

Therefore, relevant legal praxis in relation to taxation and transfer pricing should be taken into account in Russia at least in cases where tax legislation provides no straight answers to certain interpretive questions and previous court decisions of the highest courts exist in this regard. In particular, the previous decision practice of the Supreme Commercial Court may be useful, as the court dealt before with commercial questions, including taxation, and had the right to give the aforementioned clarifications to lower courts in terms of applying and interpreting specific tax law provisions. The Supreme Commercial Court has also played an important role in the development of principles, concepts and definitions of tax law,<sup>106</sup> which cannot be disregarded when making decisions relating to taxation in practice.

At present, the highest courts of Russia have merged, and there is only one court of highest instance — the Supreme Court. All the matters that used to fall under the jurisdiction of both of the highest courts fall nowadays under the jurisdiction of the Supreme Court, including questions regarding taxation. Thus, in addition to the previous decisions of the Supreme Commercial Court, the decisions of the Supreme Court may as of 6 August 2014 play a pivotal role in Russian tax law.<sup>107</sup> Furthermore, it should be observed that the Constitutional Court of Russian Federation (*Konstitutsionnyj Sud Rossijskoj*

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Federation (*Federal'nyj konstitutsionnyj zakon ot 28.04.1995 N 1-FKZ (red. ot 22.12.2014) "Ob arbitrazhnykh sudakh v Rossijskoj Federatsii"*). See also the Supreme Commercial Court's decision on approving the rules of procedure for commercial courts (*Postanovlenie Plenuma Vysshego Arbitrazhnogo Suda RF ot 5 iyunya 1996 g. N 7 "Ob utverzhdenii Reglamenta arbitrazhnykh sudov"*), items 49–92; Orlov 2001, p. 3; and Orlov 2010, p. 17. In the legal literature, it has been considered that the rulings of the highest courts may have to a certain degree a constitutive effect – notwithstanding the above stated fact that only legislated legal norms are traditionally considered official sources of law; see about this in Sedukina 2004, p. 15.

<sup>106</sup> Such as the principle of unjustified tax benefit, which is dealt with in more detail in Section 5.5 of this study. The establishment of commercial courts in Russia can be regarded as one of the most important achievements of the court system reform from the perspective of foreign companies, see in more detail Lee 2001, pp. 718–719.

<sup>107</sup> See law No. 2-FKZ of 5 February 2014. It should be noted that the Supreme Commercial Court's former legal praxis, especially the presidium's and plenary session's decisions with regard to providing clarifications on tax law provisions, is still effective and must be followed by the lower commercial courts, unless the Supreme Court overrules it by giving new rulings on the same matter; see Article 170 of the Russian Commercial Procedure Code (*Arbitrazhnyj protsessual'nyj kodeks Rossijskoj Federatsii ot 24.07.2002 N 95-FZ (red. ot 30.12.2015)*). More about the reform of the highest courts of Russian Federation especially from the point of view of commercial courts, see Hanninen 2015a, pp. 924–938.

*Federatsii*) has given rulings also in relation to taxation, and therefore its decisions may be of practical relevance on certain occasions.<sup>108</sup>

In Finland, court decisions are regarded as *poorly binding source of law*. Consequently, the ignorance of court decisions does not result in misconduct in office, although court decisions must be taken into account in decision-making, and deviations from legal praxis must be validated.<sup>109</sup> Especially the precedents made by the highest courts, the Supreme Court of Finland (*Korkein oikeus*) and the Supreme Administrative Court of Finland (*Korkein hallinto-oikeus*), must be noted in practice.

The Supreme Administrative Court of Finland has decided, and decides, to a great extent on matters relating to taxation and is therefore a very remarkable source of law in the field of tax law.<sup>110</sup> Even though the precedents of the Supreme Administrative Court of Finland are not strongly binding on tax authorities and lower courts, they may feel obliged to follow the court praxis of the Supreme Administrative Court, if it has made decisions regarding the same or even similar tax matters. If tax authorities or lower courts make decisions contrary to the legal praxis of the Supreme Administrative Court, there might be a risk that a taxpayer appeals against such decisions, after which it is also likely that the Supreme Administrative Court decides such cases in favor of the taxpayer in accordance with its previous decision practice. The decisions of the Supreme Administrative Court may sometimes also have a constitutive effect, which means that some concepts and principles of tax law have been established in its decision-making practice before they have been

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<sup>108</sup> It has the power to deviate from literal interpretation of legal norms when it supervises the compliance with the Constitution of the Russian Federation. It has decided, among other things, that ambiguous legal provisions should be interpreted in favor of taxpayers and that the tax authorities may not carry out tax audits after tax decisions have become final, see the Constitutional Court decisions *Postanovlenie Konstitutsionnogo Suda RF ot 15.07.1999 g. N 11-P "Po delu o proverke konstitutsionnosti otidel'nykh polozhenij Zakona RSFSR "O Gosudarstvennoj nalogovoj sluzhbe RSFSR" i Zakonov Rossijskoj Federatsii "Ob osnovakh nalogovoj sistemy v Rossijskoj Federatsii" i "O federal'nykh organakh nalogovoj politicii"*) and *Postanovlenie Konstitutsionnogo Suda RF ot 17.03.2009 N 5-P "Po delu o proverke konstitutsionnosti polozheniya, soderzhashhegosya v abzatsakh chetvertom i pyatom punkta 10 stat' 89 Nalogovogo kodeksa RF, v svyazi s zhaloboj obshchestva s ogranichennoj otvetstvennost'yu "Varm".*" The former principle is today regulated in the Tax Code, see Article 3 of the Tax Code. See also Orlov 2011, pp. 87–88.

<sup>109</sup> The sources of law are divided in Finland into strongly binding (acts and custom), poorly binding (legislature's intention and court decisions) and permitted (jurisprudence and legal principles) sources of law, see Aarnio 1989, pp. 220–221 and Koskinen – Virta 1996, p. 1.

<sup>110</sup> Andersson 2014, p. 12.

regulated in the tax legislation.<sup>111</sup> Thus, taken together, taxpayers cannot ignore the applicable legal decisions of the Supreme Administrative Court in practice.

Compared to Russian law, Finnish law gives more weight to case law as a legal source. Nevertheless, as the decisions of the highest courts have been followed in Russia in practice, and they have even been considered legally binding to a certain extent, there are no major differences between Russian and Finnish law in this regard.<sup>112</sup> Hence, the decisions of the highest courts may provide useful interpretive help in tax matters in both countries.

U.S. law does not bring significant differences in this respect. Contrary to the situations in Finland and especially in Russia, there is no ambiguity in considering courts decisions as legal sources in the USA. Case law is regarded as one of the primary sources of law. Case law has been described in the USA as rules of law announced through court decisions. These kinds of rules interpret provisions of the Constitution of the USA and statutes as well as regulations of the administrative agencies.<sup>113</sup>

A full print copy of the IRC comprises approximately 3,500 pages, and therefore it is no surprise that there have been many court decisions dealing with the interpretation of the IRC's provisions.<sup>114</sup> In the field of taxation, the trial courts (i.e. the courts of first instance) are the U.S. Tax Court, the U.S. District Court and the U.S. Court of Federal Claims. The decisions of the trial courts may be appealed to the appellate courts, which are the U.S. Court of Appeals, the Federal Circuit Court of Appeals and the U.S. Supreme Court.<sup>115</sup>

The legal praxis of the U.S. courts may thus play a pivotal role, when the IRC's provisions and regulations of the tax authorities are interpreted. Nevertheless, when examining particularly decisions of the Tax Court, it must be observed that its decisions may contain different conclusions even in similar cases. This is due to the fact that the Tax Court follows in its decision-making the precedents of that appellate court, which has the jurisdiction over the taxpayer

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<sup>111</sup> Myrsky 2011, p. 57 and Myrsky – Linnakangas 2006, pp. 14–15. See e.g. decisions KHO 1987 T 2036–2037 and KHO 2010 T 3711, in which the Supreme Administrative Court has established different concepts of tax law.

<sup>112</sup> Case law regarding taxation has been considered in the legal literature to have even more important role in Russia than in Finland, see Matilainen 2007, p. 252.

<sup>113</sup> Clarkson – Miller – Cross 2010, pp. 4–5.

<sup>114</sup> Sawyers – Raabe – Whittenburg – Gill 2015, p. 151.

<sup>115</sup> Ibid pp. 150–151, Wittendorff 2010a, pp. 30–31 and Lederman 2012b, pp. 902–903. In addition, see Geier 1986, pp. 427–456.



in the given case (the so-called *Golsen Rule*<sup>116</sup>). Therefore, the Tax Court may reach contradictory conclusions, even in cases where the facts of the cases are identical, if the appellate courts have decided differently on certain tax issues.<sup>117</sup>

## 2.1.4 TAX ADMINISTRATION AND GUIDANCE

The tax bodies of the Russian Federation form a coherent ensemble, which oversees the observance of the provisions of Russian tax legislation. Such bodies of the Russian tax administration are the Federal Tax Service (*Federal'naya nalogovaya sluzhba*, hereinafter referred to as the FTS) — which has the power to, inter alia, monitor and control taxes and tax collection — and its regional offices. On the other hand, the FTS itself acts under the control of the Minfin.<sup>118</sup> It is noteworthy to observe that, pursuant to Article 105.17 of the Tax Code, the FTS also exercises control over the compliance with transfer pricing regulations.

Both the FTS and the Minfin have published useful guidance in relation to the interpretation of the Russian tax provisions. According to Article 34.2 of the Tax Code, the Minfin has the authority to give written clarifications or letters (*pis'mennye raz "yasneniya*) concerning the interpretation of the Tax Code's provisions. Written clarifications do not, however, form legal norms or amend/revoke existing legal provisions. In addition, the Minfin's written clarifications are not legally binding but rather informative and clarifying in nature. Taxpayers and tax authorities are not obligated to comply with written clarifications.<sup>119</sup> As a result, it may be difficult for taxpayers to predict when the tax authorities are willing to follow the principles and positions set out in written clarifications and when they disregard them. In any case, as the Minfin's written clarifications may provide useful interpretive help in

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<sup>116</sup> *Golsen v. Commissioner of Internal Revenue*, U.S. Tax Court 54 T.C. 742, 757 (1970), aff'd, 445 F.2d 985 (10th Cir.), cert. denied, 404 U.S. 940 (1971).

<sup>117</sup> *Sawyers – Raabe – Whittenburg – Gill* 2015, p. 157.

<sup>118</sup> Article 30 of the Tax Code; *Butler* 2009, p. 586; *Krokhina* 2011, p. 135.

<sup>119</sup> See the Minfin's letter *Ministerstvo Finansov Rossijskoj Federatsii: Pis'mo ot 7 avgusta 2007 g. N 03-02-07/2-138 (Raz"yasneniya polozhenij nalogovogo zakonodatel'stva v chasti stat'i 34.2 Nalogovogo kodeksa RF)*. The letter provides more detailed information in relation to Article 34.2 of the Tax Code and the Minfin's right to publish written clarifications. See more about the written clarifications' non-binding nature in the Supreme Commercial Court's plenum decision *Postanovlenie Prezidiuma VAS RF ot 16.01.2007 N 12547/06 "Ob ostavlenii bez izmeneniya opredeleniya VAS RF ot 24.08.2006 N 8519/06, kotorym bylo prekrashcheno proizvodstvo po delu o priznanii nedejstvuyushhimi pisem Minfina RF ot 05.08.2004 N 01-02-01/03-1625, ot 22.03.2006 N MM-6-21/304@."* *Lermontov* has also dealt with the matter, see *Lermontov* 2006, p. 25.

particular in situations where the content of tax provisions is unclear, it is recommended that such clarifications are followed by taxpayers.<sup>120</sup>

Furthermore, according to Article 32 of the Tax Code, tax authorities are obliged to provide written information to taxpayers and tax agents on, inter alia, existing taxes, tax legislation and their rights and liabilities. In this regard, the FTS may provide both public information, such as letters published on its website, and private, individual guidance.<sup>121</sup> The legal status of the written information corresponds to the legal status of the Minfin's written clarifications. The FTS's information, such as the letters published in public, are not legally binding in nature as they are not considered legal norms and they do not amend or revoke existing tax provisions.<sup>122</sup> On the other hand, even though the written information given by the FTS is not legally binding, it may provide useful interpretations of ambiguous provisions of tax legislation and thus should be followed by taxpayers in general.

In Finland, taxation is, similar to the situation in Russia, administrated by one body which acts directly under the Ministry of Finance of Finland

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<sup>120</sup> It should also be noted that the Minfin may give orders (*prikaz*), which have the status of a source of law, contrary to the written clarifications. They are by nature legal norms, and therefore they do not as such interpret other legal norms in a similar manner to written clarifications. Minfin may give orders on matters, which are within its competence, see more in Chapter 5 of the Minfin's order concerning its rules of procedure *Prikaz Minfina Rossii* ot 15.06.2012 N 82n (red. ot 29.11.2013) "Ob utverzhdenii Reglamenta Ministerstva finansov Rossijskoj Federatsii" and the resolution of the Government of the Russian Federation *Postanovlenie Pravitel'stva RF* ot 13.08.1997 N 1009 (red. ot 11.12.2014) "Ob utverzhdenii Pravil podgotovki normativnykh pravovykh aktov federal'nykh organov ispolnitel'noj vlasti i ikh gosudarstvennoj registratsii." The Minfin's orders concern to a great degree technical or procedural issues, and it has not discussed in its orders, for example, transfer pricing. Therefore, written clarifications that contain interpretations of existing tax and transfer pricing law are from the perspective of this research more relevant.

<sup>121</sup> See more about the FTS's obligation in Minfin's order *Prikaz Minfina* ot 2 iyulya 2012 g. N 99n "Ob utverzhdenii administrativnogo reglamenta Federal'noj nalogovoj sluzhby po predostavleniyu gosudarstvennoj usluzhi po besplatnomu informirovaniyu (v tom chisle v pis'mennoj forme) nalogoplatel'shnikov, platel'shnikov sborov i nalogovykh agentov o deystvuyushhikh nalogakh i sborakh, zakonodatel'stve o nalogakh i sborakh i prinyatykh v sootvetstvii s nim normativnykh pravovykh aktakh, poryadke ischisleniya i uplaty nalogov i sborov, pravakh i obyazannostyakh nalogoplatel'shnikov, platel'shnikov sborov i nalogovykh agentov, polnomochiyakh nalogovykh organov i ikh dolzhnostnykh lits, a takzhe po priemu nalogovykh deklaratsij (raschetov)." The FTS has published its letters on its website at [http://www.nalog.ru/rn77/about\\_fts/about\\_nalog/](http://www.nalog.ru/rn77/about_fts/about_nalog/).

<sup>122</sup> See the Minfin's letter *Pis'mo Minfina RF* ot 1 dekabrya 2009 g. N 03-05-05-05/11 and order *Prikaz Minfina Rossii* ot 15.06.2012 N 82n (red. ot 29.11.2013) "Ob utverzhdenii Reglamenta Ministerstva finansov Rossijskoj Federatsii". See about taxpayers' right to receive correct and comprehensive information about tax matters in Smirnykh 2009, pp. 99–103.

(*Valtiovarainministeriö*) — the Finnish Tax Administration (*Verohallinto*). The Finnish Tax Administration has several regional and local offices. The main duty of the Finnish Tax Administration is to secure the tax collection and remit the tax revenue to tax recipients, who take care of the maintenance of the society; such tax recipients include, inter alia, the state, the municipalities and the Social Insurance Institution (*Kansaneläkelaitos*).<sup>123</sup> Pursuant to § 2.1 of the Finnish Act on Tax Administration (*Laki Verohallinnosta*, 11.6.2010/503), the Finnish Tax Administration's duty is also to, among other things, practice tax control, administrate taxation and safeguard the tax recipients' interest. As of 2012, all transfer pricing issues have been taken care of by the Finnish Large Taxpayers' Office (*Konserniverokeskus*), which is part of the Finnish Tax Administration. The Finnish Large Taxpayers' Office has a specific transfer pricing unit, which deals with the questions in relation to transfer pricing.<sup>124</sup>

According to § 2.2 of the Finnish Act on Tax Administration, the Finnish Tax Administration must contribute to the correct and uniform taxation and develop the Tax Administration's service abilities. For this purpose, the Finnish Tax Administration has published and publishes different kinds of guidelines concerning taxation. Regardless of not being legally binding in nature, the guidance may offer remarkable value in practice. Lower-tier authorities generally follow such guidelines and comply with them as if they were legally binding on them. Some of the guidelines may provide recommendations for interpretations of tax law provisions, and in this way, the Tax Administration may take a stand on the interpretation of certain problematic tax questions.<sup>125</sup>

It should also be observed that, in addition to the above-mentioned tasks of the Finnish Tax Administration, the Finnish Central Tax Board (*Keskusverolautakunta*) and the Finnish Large Taxpayers' Office, both being part of the Finnish Tax Administration, may give preliminary rulings on various taxation issues.<sup>126</sup> Although the said authorities are not courts, their preliminary rulings can have the value of precedent, in which case the decisions may correspond to the decisions of the Supreme Administrative

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<sup>123</sup> Myrsky – Räsänen 2011, p. 12.

<sup>124</sup> See e.g. Waal – Pykönen 2014, p. 555; Finnish Tax Administration: Client Event 2014, pp. 2, 5–8; Finnish Tax Administration: Transfer Pricing.

<sup>125</sup> Myrsky – Linnakangas 2006, pp. 15–16; Myrsky 2011, pp. 44–45, 52–53. See also Kontkanen 2002, p. 219. The Finnish Tax Administration publishes its guidelines on its website (<http://www.vero.fi>).

<sup>126</sup> See Chapter 8 of the AAP. See also the Finnish Tax Administration's guidelines A15/200/2013 in this respect.

Court of Finland.<sup>127</sup> Therefore, the decision practice of the Finnish Central Tax Board and the Finnish Large Taxpayers' Office cannot also be disregarded.

The organization of tax administration in Finland, as well as its duties and tasks, largely correspond to the situation in Russia. Both countries' tax authorities may provide additional information and guidance on taxation issues, which are not legally binding, but may give helpful interpretations of tax provisions and are broadly followed in practice. The most visible difference between the countries' tax administrations is that the Ministry of Finance of Finland itself does not provide additional guidance as actively as the Minfin in Russia and the fact that, contrary to the Russian authorities, the Finnish authorities may give preliminary rulings, which may even in some cases have the value of a precedent.

Taxation is administered in the USA by the Internal Revenue Service (hereinafter referred to as the IRS), which is a bureau of the U.S. Treasury Department. The latter resembles the Minfin and the Ministry of Finance of Finland. The IRS is responsible for, inter alia, auditing tax returns, collecting taxes and enforcing the tax laws of the USA.<sup>128</sup> It works under the supervision of the Commissioner of the IRS. It must be observed that the IRS controls over the transfer pricing issues in the USA.

Tax authorities may provide taxpayers with a wide range of different kinds of guidance in relation to the tax laws of the USA and interpretation thereof. The administrative regulations and rulings provided by the tax authorities are considered as one of the primary sources of U.S. tax law. More importantly, the administrative interpretations of the IRC should always be examined first, and only if the administrative pronouncements fail to provide answers. For example, with regard to interpreting certain provisions of the IRC, the judicial interpretations (i.e. decisions of the courts) should be taken into account.<sup>129</sup> Hence, it is reasonable to discuss the most important administrative sources in more detail below.

First, the U.S. Treasury Department may publish the so-called *Treasury Regulations*, which contain interpretations of the IRC's provisions. According to Section 7805 of the IRC, "except where such authority is expressly given by this title to any person other than an officer or employee of the U.S. Treasury Department, the Secretary shall prescribe all needful rules and regulations for the enforcement of this title, including all rules and regulations as may be necessary by reason of any alteration of law in relation to internal revenue." In

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<sup>127</sup> Myrsky 2011, pp. 8 and 109.

<sup>128</sup> Sawyers – Raabe – Whittenburg – Gill 2015, p. 118.

<sup>129</sup> Sawyers – Raabe – Whittenburg – Gill 2015, p. 150.

addition to this provision dealing with a general authority, the IRC includes provisions according to which the Secretary of the U.S. Treasury Department has been granted to issue regulations on certain matters for the purposes specified in such provisions.<sup>130</sup> The Treasury Regulations based on the general authority (Section 7805) have been traditionally called *interpretive regulations*, and regulations issued under specific IRC provisions have been called *legislative regulations*.<sup>131</sup> Treasury Regulations can be divided into three different categories: proposed regulations, final regulations and temporary regulations.<sup>132</sup> The final and temporary regulations are codified in Title 26 (“Internal Revenue”) of the Code of Federal Regulations (hereinafter referred to as CFR).<sup>133</sup>

The Treasury Regulations cannot be ignored by the taxpayers. Especially the final regulations may have the effect of law and should be followed by the courts, if the U.S. Congress, as the legislator, has not addressed certain specific questions, and the Treasury Regulation, which addresses such questions, is not “arbitrary, capricious or manifestly contrary to the statute” (test introduced in *Chevron*<sup>134</sup>). Furthermore, pursuant to Section 553(b) – (c) of the Administrative Procedure Act of 1946, to be legally effective, the public should have also been given a notice and an opportunity to comment on such Treasury Regulations.<sup>135</sup> As the final regulations usually meet the mentioned requirements, both the courts and taxpayers must follow them in practice.

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<sup>130</sup> See e.g. Sections 108 (c)(5) and 6103 of the IRC.

<sup>131</sup> Lederman 2012a, pp. 647, 654–655 and Bankman – Griffith – Pratt 2008, pp. 24–25.

<sup>132</sup> Treasury Regulations are usually first *proposed regulations*, which provide the U.S. Treasury Department’s interpretations of certain IRC provisions. Taxpayers and the public may comment on the proposed regulations. After the public hearing, and possible amendments to the proposed regulations, they become *final regulations* and will be published as Treasury Decisions in the Federal Register. When tax law (provisions) or interpretation thereof has been changed due to congressional or judicial amendments, the Secretary of the U.S. Treasury Department may publish *temporary regulations*, which are effective immediately and in force for no more than three years after the date of issuance of such regulations. The purpose of the temporary regulations is to provide instant assistance for the taxpayers in relation to applying newly adopted tax law provisions; see Section 7805 of the IRC; Section 4.10.7.2.3.3 of the Internal Revenue Manual; Bankman – Griffith – Pratt 2008, p. 25; and Sawyers – Raabe – Whittenburg – Gill 2015, pp. 119–120.

<sup>133</sup> 26 CFR 1.482.

<sup>134</sup> *Chevron U.S.A., Inc. v. Natural Resources Defense Council, Inc.*, 467 U.S. 837 (1984).

<sup>135</sup> Lederman 2012a, pp. 659–664. The legal effects of the Treasury Regulations were earlier decided on the basis of whether the regulations were interpretive or legislative, but after such cases as *United States v. Mead Corp.*, 533 U.S. 218 (2001) and *Mayo Found. for Med. Educ. & Research v. United States*, 131 S. Ct. 704, 713 (2011), the distinction between interpretive regulations and legislative regulations is not any more relevant, and both types of regulations should receive judicial deference to a same degree if regulations fulfill the mentioned requirements introduced in *Chevron*.

Temporary regulations are subject to the same requirements and may have legal effect up to a maximum of three years,<sup>136</sup> although in the legal literature there has been doubts as to whether such regulations fulfill both requirements.<sup>137</sup> It should be observed that, because the final, temporary and even proposed regulations represent the position of the IRS in relation to certain IRC provisions, the IRS itself has an obligation to follow the Treasury Regulations.<sup>138</sup> Overall, it must be highlighted that the Treasury Regulations provide useful information for taxpayers with regard to ambiguous IRC provisions, and quite often taxpayers and courts as well as the tax authorities are also obligated to follow them. Even in cases where Treasury Regulations lack legally binding character, taxpayers can justify their actions by relying on them as they could rely on the actual IRC provisions.<sup>139</sup>

Treasury Regulations are not the only administrative sources of tax law that should be taken into account when taxpayers make decisions concerning taxation and transfer pricing in the USA. In addition to Treasury Regulations, the IRS provides various pronouncements in relation to the tax law provisions and interpretation thereof. Especially the IRS's *revenue rulings* are of great importance when the provisions of the IRC are interpreted. The revenue rulings represent the IRS's official interpretations of how particular IRC provisions and/or Treasury Regulations should be applied to a given case under its specific circumstances. The case has been usually submitted by a taxpayer.<sup>140</sup> The revenue rulings lack the same status and legal effect as the Treasury Regulations. Nevertheless, they can be used as precedents and taxpayers may rely on them, if in their cases "the facts and circumstances are substantially the same." When taxpayers apply such revenue rulings to their cases, they must also take into consideration subsequent legislation, regulations, court decisions, rulings and procedures.<sup>141</sup> Other useful administrative guidelines and pronouncements of the IRS include *Revenue Procedures*, *private letter rulings*, *notices*, *General Counsel Memoranda* and the IRS's internally used *Internal Revenue Manual*.<sup>142</sup>

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<sup>136</sup> Wittendorff 2010a, p. 26.

<sup>137</sup> It has been stated in the legal literature that the temporary regulations have not usually undergone the notice-and-comment procedure, which is why it is not completely clear whether temporary regulations can be legally binding due to *Chevron*, see Lederman – Mazza 2011, pp. 1–2. See also Hickman (2013), pp. 492–502.

<sup>138</sup> Section 4.10.7.2.3.4 of the Internal Revenue Manual.

<sup>139</sup> Rogovin – Korb 2008, pp. 328–329.

<sup>140</sup> Sawyers – Raabe – Whittenburg – Gill 2015, pp. 123–124; Lederman 2012a, pp. 664–665. Revenue rulings are published in the *Internal Revenue Bulletin*.

<sup>141</sup> Section 1.2.16.1.11 and 4.10.7.2.6.1 of the Internal Revenue Manual; Treas. Reg. § 601.601(d)(2).

<sup>142</sup> *Revenue Procedures* are pronouncements by the IRS in relation to its internal procedures and administration of tax laws. They provide taxpayers with information regarding e.g. compliance with the

These administrative sources may lack the same weight as a legal source as the revenue rulings or the Treasury Regulations, but they may still provide useful information for taxpayers, when tax law provisions are interpreted. In contrast to Russian and Finnish tax law, the administrative sources of law are of greater importance in U.S. tax law. As mentioned above, certain tax administration's publications — in particular, the Treasury Regulations — have even more weight as a source of tax law than the court decisions in the USA. Even though the administrative sources should be taken into consideration in Russia and Finland, the current legal state in the USA deviates remarkably in this respect.

## 2.2 SOURCES REGULATING TRANSFER PRICING AND THE ARM'S LENGTH PRINCIPLE

### 2.2.1 CONCEPT OF TRANSFER PRICING AND THE ARM'S LENGTH PRINCIPLE

As discussed, *transfer pricing* can be defined as a tax law phenomenon concerning the pricing or other commercial conditions of business transactions that are executed between related corporate parties, in general companies within the same group of companies. Market forces have no impact on transactions between these kinds of associated parties to the same extent as on transactions between totally independent parties.<sup>143</sup> Transactions between related parties, such as the companies within the same group, are usually affected by the group's common interests.<sup>144</sup> Transfer pricing may motivate the group to transfer part of its profits to jurisdictions with lower

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procedural issues of tax returns. Revenue Procedures are also published in the *Internal Revenue Bulletin*. In *private letter rulings*, the IRS takes a stand on tax effects of a specific transaction or other issue planned by a taxpayer, who has requested for a private letter ruling. A private letter ruling is not officially published, but only issued to the taxpayer who requested for the ruling and it is only binding between the IRS and the taxpayer. Although private letter rulings lack precedential value, they may provide useful information about possible tax treatment of certain type of transactions. The *General Counsel Memoranda* are memoranda prepared by the office of the IRS's Chief Counsel for internal use of the IRS, in general for the purpose of providing assistance in drafting revenue rulings and private letter rulings. The *notices* are public statements, which may provide guidance on the interpretation of the IRC's provisions, see Sawyers – Raabe – Whittenburg – Gill 2015, pp. 125–129, 134; Wittendorff 2010a, pp. 23, 29; and Section 4.10.7.2.6 of the Internal Revenue Manual. *Internal Revenue Manual* provides official guidelines for the personnel of the IRS, but it does not constitute law, and the IRS is not bound by it, see e.g. decision *United States v. Horne* 714 F.2d 206 (1st Cir. 1983) (per curiam).

<sup>143</sup> Myrsky – Linnakangas 2009, p. 269; Wittendorff 2010a, p. 3.

<sup>144</sup> Helminen 2012, p. 217.

income tax rates, for instance, by using exorbitant prices or underprices in its internal transactions, such as the sale of goods or services.<sup>145</sup> The prices or other commercial terms that do not correspond to actual costs may lead to a situation where taxable income fails to accrue equally between the countries in question. Consequently, all the involved countries may not be able to use their right to levy taxes within their territory.<sup>146</sup> The concept of transfer pricing is universal and has therefore the same meaning also under Russian, Finnish and U.S. law.<sup>147</sup>

*The arm's length principle* (in Russian *princip vytyanutoj ruki*, in Finnish *markkinaehtoperiaate*) is an international principle guiding transfer pricing, and the most important sources regulating it (in addition to national sources) are Article 9 of the OECD Model Tax Convention and the OECD Transfer Pricing Guidelines.<sup>148</sup> Pursuant to Article 9 of the OECD Model Tax Convention, “where conditions are made or imposed between the two [associated] enterprises in their commercial or financial relations which differ from those which would be made between independent enterprises, then any profits which would, but for those conditions, have accrued to one of the enterprises, but, by reason of those conditions, have not so accrued, may be included in the profits of that enterprise and taxed accordingly.” The provision under the mentioned Article 9 represents the arm’s length principle.<sup>149</sup>

The arm’s length principle under Article 9 of the OECD Model Tax Convention states in principle that, in their transactions, associated parties must use conditions used by independent parties under similar circumstances or otherwise the profits, which should have been accrued to one of the parties as a result of the transaction, will be added to the profits of that company for the purpose of (income) taxation. According to the OECD Transfer Pricing Guidelines, arm’s length principle is an international standard of transfer pricing, which should be followed by multinational enterprises and tax

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<sup>145</sup> Helminen 2009, p. 211.

<sup>146</sup> Rohatgi 2002, p. 412.

<sup>147</sup> See e.g. Engblom et al. 2010, pp. 521–523; Levey – Wrappe – Chung 2006, p. 11; Nepesov 2007, pp. 3–4. In the Russian legal literature, however, there has been differing opinions and understandings of the exact meaning of transfer pricing or its application environment, see in more detail in Vasil'eva 2009, pp. 1–6.

<sup>148</sup> These transfer pricing guidelines are based on already in 1979 published first transfer pricing report by the OECD (*Transfer Pricing and Multinational Enterprises*). See more in Karjalainen – Raunio 2007, pp. 14–15.

<sup>149</sup> OECD Model Tax Convention commentary, p. 185. See also similar provision in Article 9 of the United Nations Model Double Taxation Convention between Developed and Developing Countries.



administrations for taxation purposes in the OECD member countries.<sup>150</sup> If the transfer pricing of a transaction between related parties fails to take into account the market forces and the arm's length principle, the profits of these companies can be adjusted by establishing that kinds of terms and conditions for the transaction, which could be expected by the OECD member states in similar transactions between independent parties under similar conditions.<sup>151</sup> The OECD Transfer Pricing Guidelines also provide guidance for the application of arm's length principle in various situations; especially the chapter dealing with the transfer pricing aspects of business restructurings, Chapter IX, is important given the topic of this research.

## **2.2.2 NATIONAL SOURCES OF TRANSFER PRICING AND APPLICABILITY OF THE OECD TRANSFER PRICING GUIDELINES**

Prior to the introduction of the transfer pricing regulations in force at the moment, the Tax Code's transfer pricing provisions could be considered restricted and ineffective. Due to the lack of their clarity, the Russian tax authorities frequently lost transfer pricing cases in courts.<sup>152</sup> Therefore, it was in the state's interest to enact new functioning transfer pricing provisions<sup>153</sup> by Federal Law No 227-FZ (*N 227-ФЗ*), which was signed by Dmitry Medvedev, the prevailing president at that time, in July 2011. Russia started applying its newest transfer pricing rules regulated in Chapter V.1 of the Tax Code at the beginning of 2012. The new provisions are sensational and progressive, and their introduction has been described as the biggest reform in Russian tax law after enacting the actual Tax Code. They are also very comprehensive, as they cover almost everything relating to general transfer pricing concepts and definitions, transfer pricing methods, documentation requirements as well as transfer pricing audit. It should also be observed that they are widely based on the OECD Transfer Pricing Guidelines.<sup>154</sup>

The reform introduced several changes in Russian tax law, the most significant from the transfer pricing perspective being, inter alia, the application of the

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<sup>150</sup> OECD Transfer Pricing Guidelines, 1.1. The OECD overall has an important role in international tax law; see more in Ellingsworth 2009, pp. 273–279.

<sup>151</sup> OECD Transfer Pricing Guidelines, 1.3.

<sup>152</sup> Matilainen Edilex 2010. Since 2001, the tax authorities had lost approximately 90 per cent of transfer pricing disputes against taxpayers in the commercial courts of Russia; see Blagov 2009, pp. 115–116.

<sup>153</sup> See Articles 105.1–105.25 of the Tax Code. The newest provisions have been largely ignored by legal commentaries that Russian lawyers read in conjunction with the provisions of laws. See one of the few commentaries, Lermontov 2011.

<sup>154</sup> Kaftannikov 2011, p. 9; Overchuk 2012, p. 1.

arm's length principle in general in Russian transfer pricing and taxpayers' possibility to conclude advance pricing agreements (hereinafter referred to as APAs; in Russian *soglashenie o tsenoobrazovanii dlya tselej nalogooblozheniya*). Another particularly noteworthy issue is that the so-called *safe-harbor provision* was removed from the Tax Code.<sup>155</sup> Article 40 of the Tax Code regulated previously that the authorities had the right to intervene in related parties' transactions only if the contract price was *at least* 20 per cent higher or lower than the market price in similar transactions executed under similar circumstances; this resulted in that related companies were entitled to use in their transactions transfer prices which deviated to some extent from the market prices as long as they did not deviate by more than 20 per cent.<sup>156</sup> Moreover, the reform was designed to eliminate the prevailing ambiguousness of provisions, make tax control more efficient and minimize risks relating to transfer pricing.<sup>157</sup>

Although the provisions are extensive, they are not all-embracing. Many interesting and timely issues from the transfer pricing perspective remain unsolved in the Tax Code. For instance, business restructuring has been left without any attention in Chapter V.1 of the Tax Code. Notwithstanding the fact that the overall judicial discretion in Russian law is basically based only on its legislation's legal norms, the possible court decisions<sup>158</sup> as well as the Minfin's and the FTS's guidance must be taken into consideration, when the Tax Code's transfer pricing provisions are interpreted – despite the fact that they are not legally binding in the above-mentioned manner. Especially the Minfin's and the FTS's letters and written clarifications provide interpretive help in many transfer pricing questions; they have published guidance, for instance, relating to the transfer pricing notification and documentation liability<sup>159</sup>, APA

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<sup>155</sup> A safe-harbor rule is a provision, which defines the conditions for circumstances in which tax authorities do not interfere in certain transactions' transfer pricing issues. In such cases, it is possible that simplified procedures are applied to particular transactions, or that some specific transactions may be left entirely outside of the scope of transfer pricing regulations; see Helminen 2009, p. 248.

<sup>156</sup> The provision was prone to criticism and was criticized, inter alia, by the OECD, see Blagov 2008, p. 288. It was not considered fully successful from the state's and tax authorities' perspective either, see Kasatkin – Frolov 2005, pp. 248–249.

<sup>157</sup> Blagov 2009, p. 115.

<sup>158</sup> There have not yet been published remarkable court decisions where the highest courts (nowadays the Supreme Court) would have specifically interpreted some of the Tax Code's *new* transfer pricing provisions. On the other hand, the court decisions regarding the Tax Code's *former* transfer pricing provisions may still be important and bring clarity at least in some cases.

<sup>159</sup> See e.g. Pis'mo FNS Rossii ot 02.07.2013 N OA-4-13/11860@ "O zapolnenii uvedomlenij o kontroliruemykh sdelkakh" and Prikaz FNS Rossii ot 16.11.2012 N MMV-7-13/877@ (red. ot 28.10.2014) "O vnesenii izmenenij v Prikaz FNS Rossii ot 10.05.2012 N MMV-7-13/298@."

procedure<sup>160</sup> and the scope of application of the Tax Code's transfer pricing regulations<sup>161</sup>.

Nonetheless, the transfer pricing provisions of the Tax Code are quite widely consistent with the OECD's transfer pricing rules, despite their own peculiarities.<sup>162</sup> In addition, while the Tax Code's transfer pricing provisions are quite new, they lack specific rules relating to business restructurings in comparison with Chapter IX of the OECD Transfer Pricing Guidelines. The key question therefore is, could the OECD Transfer Pricing Guidelines be used as interpretive help in business restructurings in Russia at least in situations where the Tax Code's transfer pricing provisions remain silent?

Russia is not a member of the OECD, and hence the OECD Transfer Pricing Guidelines, which are not legally binding even on its member states, cannot be binding on Russia. Nonetheless, Russia has been planning to join the OECD already for several years.<sup>163</sup> When — and if — it finally becomes a member of the OECD, it will be in a similar position as Finland, the USA and other OECD member states, i.e. the national authorities and courts are encouraged to follow the OECD Transfer Pricing Guidelines,<sup>164</sup> resulting in that they should also be, at least to some extent, followed in practice. As mentioned earlier, the new Russian transfer pricing provisions are already widely based on the OECD Transfer Pricing Guidelines. Among other things, the Tax Code's transfer pricing methods are equivalent to the methods specified in the OECD Transfer Pricing Guidelines. It is also worth mentioning that Russian legal commentaries have taken as a starting point that the OECD Transfer Pricing Guidelines could be used as interpretive help when the Tax Code's transfer pricing provisions are interpreted and applied in practice.<sup>165</sup> The FTS's representatives have also made unofficial statements, according to which the OECD Transfer Pricing Guidelines may be helpful when interpreting the Tax Code's transfer pricing provisions.<sup>166</sup>

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<sup>160</sup> Pis'mo Federal'noj nalogovoj sluzhby Rossii ot 12.01.2012 N OA-4-13/85@ "O zaklyuchenii soglashenij o tsenoobrazovanii dlya tselej nalogooblozheniya."

<sup>161</sup> Pis'mo Federal'noj nalogovoj sluzhby ot 6 marta 2014 g. N ZN-3-13/878@ O primenenii polozhenij razdela V.I NK RF.

<sup>162</sup> See about peculiarities in e.g. Gregory 2012, p. 870. In this study, the differences between the provisions of the Tax Code and the OECD Transfer Pricing Guidelines are discussed in the following chapters, when specific transfer pricing questions are reviewed in more detail.

<sup>163</sup> Bell 2012, p. 818.

<sup>164</sup> OECD Transfer Pricing Guidelines, Preface, 15–17.

<sup>165</sup> See e.g. Kaftannikov 2011, p. 9.

<sup>166</sup> Russian tax authorities were interviewed by legal portal Garant.ru. Interview can be found here: <http://www.garant.ru/action/interview/369396/> (Novye pravila transfertnogo tsenoobrazovaniya: plyusy i minusy. Internet-interv'y u s nachal'nikom Upravleniya transfertnogo tsenoobrazovaniya i

In light of the above-mentioned considerations, it is justified to state that the OECD Transfer Pricing Guidelines cannot be entirely ignored in Russia and can — at least to some extent — be used as *interpretive help* in situations where the application of the Tax Code's transfer pricing provisions results in ambiguous conclusions, provided that the wording, content or scope of the provision is not actually broadened. This requirement stems from the legislated legal norms' superior position in the hierarchy of sources of law in Russia. Also, tax practitioners share this view and consider this conclusion justified.<sup>167</sup>

In Finland, transfer pricing is not regulated in the tax legislation as widely as in the Tax Code in Russia, where it has been regulated extremely extensively. The only specific transfer pricing provisions can be found in § 31 of the AAP, which concerns transfer pricing adjustment,<sup>168</sup> and in § 14 a – § 14 e of the AAP, which deals with the transfer pricing documentation requirements, and even these provisions do not provide much information. The transfer pricing adjustment provision came into force on 1 January 2007, and it — in conjunction with the former transfer pricing documentation provisions — has generally been regarded as the first real transfer pricing regulation in Finland.<sup>169</sup> Before introducing these transfer pricing rules, the most relevant provision, which was applied to transfer pricing issues more or less, was the AAP's former, already repealed, § 31 regulating the international hidden dividend distribution.

As was the case in Russia, the arm's length principle has also been regulated in the Finnish transfer pricing provisions. According to the preliminary works of the AAP (HE 107/2006 vp), the objective of imposing the above-discussed transfer pricing regulations in Finland was to avoid lagging behind other countries in the international development of transfer pricing. In addition, the preliminary works state that OECD Transfer Pricing Guidelines worked as a model in many respects when the AAP's provisions were drafted, and therefore the transfer pricing regulations of the AAP are in principle equivalent to the OECD Transfer Pricing Guidelines.<sup>170</sup> As the AAP provides taxpayers and tax authorities only with very restricted transfer pricing regulations in terms of

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mezhdunarodnogo sotrudnichestva FNS Rossii). Published on 21 December 2011. Accessed 10 February 2013.

<sup>167</sup> Expert Interview 2012.

<sup>168</sup> For tonnage tax purposes, similar provision can be found in the Finnish Tonnage Tax Act (*tonnistoverolaki*, 5.6.2002/476), see § 16.

<sup>169</sup> Karjalainen – Raunio 2007, pp. 11–16 and the Finnish Tax Administration Memorandum 1471/37/2007, p. 3.

<sup>170</sup> HE 107/2006 vp, pp. 3, 10–11, 14–18.

the actual content, other sources of law become important in Finland. In addition to the mentioned preliminary works, particularly the guidelines provided by the Finnish Tax Administration and the OECD Transfer Pricing Guidelines play a significant role.

Especially the Finnish Tax Administration's memorandum regarding the documentation of transfer pricing (*Siirtohinnoittelun dokumentointi*, 1471/37/2007)<sup>171</sup> is of great importance in this respect providing detailed information on, inter alia, performing functional and comparability analyses in the course of preparing transfer pricing documentation as well as on transfer pricing methods. Regardless of not being legally binding (as administrative sources in general, as mentioned earlier), it gives helpful interpretations of the arm's length principle regulated in § 31 of the AAP and guidance, in particular, on how to comply with the principle in Finland; hence, it is broadly followed in practice.

The relevance of the OECD Transfer Pricing Guidelines in Finland is also discussed in the memorandum. According to the memorandum, the arm's length principle should be interpreted in accordance with the OECD Transfer Pricing Guidelines and that the transfer pricing methods to be used in the determination of arm's length compensations are the same methods that are regulated in the OECD Transfer Pricing Guidelines.<sup>172</sup> Although the OECD Transfer Pricing Guidelines are not legally binding even on the OECD member states, the Finnish Tax Administration is thus of the opinion that the principles set out in the guidelines must be followed in practice to a great degree, when the arm's length principle is applied. In its 2015 statement, the Finnish Tax Administration again confirmed the importance of the OECD Transfer Pricing Guidelines as a guiding source in interpreting the arm's length principle — § 31 of the AAP — in Finland.<sup>173</sup>

It has also been acknowledged in the legal literature that the OECD Transfer Pricing Guidelines' — as well as the OECD Model Tax Convention's — impact on the Finnish judicial system is significant and that they cannot be ignored in practice when national provisions are applied.<sup>174</sup> More importantly, the

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<sup>171</sup> The memorandum is set to be updated in the nearest future to reflect, inter alia, the OECD's latest guidance. During the finalization of this research, the 2007 version was still in force.

<sup>172</sup> Finnish Tax Administration Memorandum 1471/37/2007, pp. 4 and 36.

<sup>173</sup> The Finnish Tax Administration's statement A177/200/2015 about the use of OECD Transfer Pricing Guidelines and updates thereof as a source for interpretation (Finnish Tax Administration: Statement A177/200/2015).

<sup>174</sup> Karjalainen – Raunio 2007, p. 18. Mehtonen is of the opinion that the OECD Transfer Pricing Guidelines and the OECD Model Tax Convention are in practice strongly binding sources of law in Finland, see Mehtonen 2005, p. 50. The aforementioned preliminary works of the AAP contain also

Supreme Administrative Court of Finland has further confirmed that the OECD Transfer Pricing Guidelines should be considered as a remarkable source when the arm's length principle regulated in § 31 of the AAP is interpreted and applied in practice. However, the application of the OECD Transfer Pricing Guidelines and/or the OECD Model Tax Convention cannot result in that the wording or content of a national tax provision or tax convention provision is broadened against the legislator's intention, especially in a way that broadens the liabilities of taxpayers in tandem.<sup>175</sup>

Consequently, legal praxis and prejudices also cannot be disregarded, when the Finnish transfer pricing questions are reviewed. As discussed earlier, court decisions are to a certain degree legally binding under Finnish law. Especially the decisions of the Supreme Administrative Court of Finland should be taken into consideration, as they may bring clarifications to questions relating to transfer pricing, as seen above. The court has been particularly active in transfer pricing matters in recent years,<sup>176</sup> and it has, in addition to confirming the applicability of the OECD Transfer Pricing Guidelines in general, confirmed expressly that the principles and regulations of Chapter IX of the OECD Transfer Pricing Guidelines may be applied in Finland when the arm's length principle is interpreted.<sup>177</sup> Apart from the decisions of the Supreme Administrative Court of Finland, the aforementioned preliminary rulings of the Finnish Large Taxpayers' Office should be taken into account. Despite the fact that the Finnish Large Taxpayers' Office is not a court, its rulings may provide useful interpretations of legal provisions, and such rulings may be even considered precedents. The Finnish Large Taxpayers' Office specializes especially in transfer pricing questions as all the Finnish Tax Administration's tasks relating to transfer pricing have been within its competence as of the

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several references to the OECD Transfer Pricing Guidelines and the OECD Model Tax Convention, see HE 107/2006 vp, pp. 3, 14–19 and 21. In addition, the said OECD sources were often referred to in the Finnish legal practice already many years before drafting § 31 of the AAP in its present form, see Karjalainen – Laaksonen 2002, p. 316.

<sup>175</sup> See decision KHO 2014:119 of the Supreme Administrative Court of Finland. The case concerned in particular recharacterization of a transaction. The court was of the opinion that, as the Finnish transfer pricing adjustment provision (§ 31 of the AAP) does not specifically express the possibility of recharacterizing transactions, paragraph 1.65 of the OECD Transfer Pricing Guidelines, which previously dealt with the recharacterization of transactions, cannot be applied in Finland. See also Helminen 2014a, pp. 90–93; Helminen 2014b, pp. 15–27; Lehtonen 2014, pp. 183–193; and Laaksonen 2014b, pp. 3–5.

<sup>176</sup> See decisions KHO 2014:33 and the aforementioned KHO 2014:119. See more about the Supreme Administrative Court's recent decisions in Penttilä 2015, pp. 120–140. See also decisions KHO 2010:73 and KHO 2009:70, which also deal with transfer pricing questions. See about transfer pricing cases in the Administrative Court of Helsinki in Jaakkola et al. 2012, pp. 40–42.

<sup>177</sup> See KHO 2013:36. The case concerned the so-called locations savings. The case has been discussed also in the English legal literature; see e.g. Hoy 2013, p. 1137.

beginning of 2012. This has resulted in a constant increase in the number of preliminary rulings concerning transfer pricing issues in recent years.<sup>178</sup>

Finland as an EU member state must follow EU legislation. In the field of transfer pricing, no mandatory EU law has been published that would have an immediate effect on transfer pricing in practice. However, there are some sources that deal with transfer pricing questions and are therefore worth mentioning. First, on 27 June 2006, the Council of the EU and the member states published a resolution on a code of conduct with regard to transfer pricing documentation for related parties in the EU.<sup>179</sup> The Finnish pricing provisions on transfer pricing documentations are based on the said resolution and therefore they may be useful in the application of the AAP's provisions.<sup>180</sup> Second, the Commission to the Council, the European Parliament and the European Economic and Social Committee has published a communication on the work of the EU Joint Transfer Pricing Forum in the field of dispute avoidance and resolution procedures and on Guidelines for Advance Pricing Agreements within the EU.<sup>181</sup> The purpose of the communication is to get group companies and national authorities to agree on transfer pricing issues in advance thus avoiding the possible transfer pricing disputes. Lastly, the EU member states have concluded an intergovernmental convention on the elimination of double taxation in connection with the adjustment of profits of associated enterprises.<sup>182</sup> The convention sets a procedure for the EU member states to eliminate possible double taxation resulting from adjustments of profits.<sup>183</sup>

The actual transfer pricing legislation in the USA is, similar to the situation in Finland, content-wise very limited. Transfer pricing is regulated in Section 482 of the IRC, which is in principle the only provision that specifically

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<sup>178</sup> Waal – Pykönen 2014, p. 555.

<sup>179</sup> Resolution of the Council and of the representatives of the governments of the member states, meeting within the Council, of 27 June 2006 on a code of conduct on transfer pricing documentation for associated enterprises in the European Union (2006/C 176/01).

<sup>180</sup> See HE 107/2006 vp, pp. 11, 13, 14, 17 and 19.

<sup>181</sup> COM (2007) 71: Communication from the Commission to the Council, the European Parliament and the European Economic and Social Committee on the work of the EU Joint Transfer Pricing Forum in the field of dispute avoidance and resolution procedures and on Guidelines for Advance Pricing Agreements within the EU (SEC(2007) 246), 26 February 2007.

<sup>182</sup> Convention 90/436/EEC on the elimination of double taxation in connection with the adjustment of profits of associated enterprises, 23 July 1990; Protocol 1999/C 202/01 amending the Convention of 23 July 1990 on the elimination of double taxation in connection with the adjustment of profits of associated enterprises, 25 May 1999.

<sup>183</sup> See more about the mentioned sources of EU law in Helminen 2012, pp. 219–258. See also Karjalainen – Raunio 2007, pp. 42–44.

regulates transfer pricing in the US legislation;<sup>184</sup> it is also a narrow provision containing just a few sentences. The section deals with the IRS's right to interfere in related party transactions in order to prevent tax evasion or to ensure that the profits between parties reflect the real situation. Although Section 482 does not contain a direct mention of the arm's length principle, in Treasury Regulations it has been interpreted to represent the so-called arm's length standard.<sup>185</sup>

Regardless of the fact that the actual transfer pricing legislation is very restricted, the USA has been the forerunner in regulating transfer pricing questions. Section 482 of the IRC was first introduced already in 1917, when the USA enacted first corporate income tax legislation. The content of the provision has remained almost the same since 1928. Only in 1986, a mention in relation to transactions involving intangible assets was added to the end of the section.<sup>186</sup> Notwithstanding that there have been discussions over the years in relation to possibly amending or updating the section, it has remained unchanged.<sup>187</sup>

As the actual transfer pricing rules provided in the legislation are not extensive and lack content, the administrative sources have had, and still have, an important role in providing information on how to apply transfer pricing rules and interpret them in practice. Especially the Treasury Regulations must be mentioned, when dealing with transfer pricing questions in the USA; they can even be described as the most significant source of law in U.S. transfer pricing. Treasury Regulations interpret the IRC's narrow regulations and in this way provide specific interpretations and rules on how to apply arm's length principle to different kinds of transactions/issues and what methods should be used for determining arm's length compensations in such cases. In addition, the Treasury Regulations provide general concepts and principles with regard to transfer pricing, rules to be applied specifically to transactions concerning intangible property and guidance on transfer pricing penalties.<sup>188</sup> The Treasury Regulations have been amended and updated many times to

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<sup>184</sup> In addition to Section 482 of the IRC, the IRC contains also a section, which regulates the transfer pricing penalties; see Section 6662(e) of the IRC.

<sup>185</sup> Levey – Wrappe – Chung 2006, p. 11. Arm's length standard is the U.S. equivalent of the arm's length principle, see e.g. Bronson – Johnson – Sullivan 2014, p. 6.

<sup>186</sup> Levey – Wrappe – Chung 2006, p. 6 and Eden 1998, p. 384. See also King, 2004, pp. 9–56; Wittendorff 2010a, pp. 31–53.

<sup>187</sup> Eden 1998, pp. 386–387.

<sup>188</sup> Treas. Reg. § 1.482-1–1.482-9, § 1.6662-6.



reflect constantly changing business environments.<sup>189</sup> As stated earlier, the IRS must in practice follow the Treasury Regulations, and the final Treasury Regulations usually have legal effect, which means that the courts and taxpayers must comply with them in practice. It can be stated that the IRC's transfer pricing provisions and the related Treasury Regulations thereto form the main transfer pricing rules of U.S. tax law.

Moreover, there are also other administrative sources, which provide help in interpreting the IRC's narrow transfer pricing provisions, although they are not legally binding in nature. The IRS has published, for instance, several Revenue Procedures, which for example deal with the conclusion of APAs and taxpayer's voluntary adjustments in relation to taxable income, guidance in the Internal Revenue Manual as well as notices and the so-called Transfer Pricing Audit Roadmap regarding the procedure of transfer pricing examination and audit.<sup>190</sup> Overall, these kinds of administrative sources cannot be ignored, as they may provide helpful interpretations of Section 482 of the IRC on issues, which have not been covered at all by other sources, such as the Treasury Regulations.

Case law, as discussed above, plays an important role in U.S. tax law. Major cases have dealt with transfer pricing questions, and thus applicable court decisions must be taken into consideration, when transfer pricing provisions and regulations are applied in practice. Most cases have concerned disputes between the IRS and taxpayers. For example, the court decisions have taken a stand on the applicability of certain transfer pricing methods<sup>191</sup> and transfer pricing of intangibles<sup>192</sup>.

The USA is a member state of the OECD. The transfer pricing provisions of U.S. tax law (both the IRC's provisions and the Treasury Regulations) are mainly consistent with the OECD Transfer Pricing Guidelines. For instance, they both have, to a great extent, similar transfer pricing methods and recognize the arm's length range. Nonetheless, they also deviate in some respects from each other, and the U.S. transfer pricing rules are remarkably more detailed, which means that they regulate many questions that have not

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<sup>189</sup> See more about the transfer pricing regulation history and how Treasury Regulations have been amended in the course of time in Levey – Wrappe – Chung 2006, p. 6 and PwC 2015, pp. 1057–1059, where the latter has more of an informative nature.

<sup>190</sup> See e.g. Revenue Procedures 2008-31, 2006-9, 99-32 and 96-53; Section 4.61.3 of the Internal Revenue Manual; notice 98-65. The Transfer Pricing Audit Roadmap can be accessed at <https://www.irs.gov/Businesses/Corporations/Transfer-Pricing-Audit-Roadmap-Now-Available>. Accessed 21 February 2016.

<sup>191</sup> GlaxoSmithKline Holdings (Americas) Inc. v. Commissioner, 117 T.C. No. 1 (2001).

<sup>192</sup> Veritas Software Corporation v. Commissioner, 133 T.C. 297 (2009).

been discussed in the OECD Transfer Pricing Guidelines at all.<sup>193</sup> As there are disparities between the guidelines and the national transfer pricing rules, the OECD Transfer Pricing Guidelines may have less impact on the national law in the USA in comparison with the current legal state in Finland. However, when there is no discrepancy between the U.S. and the OECD transfer pricing rules, the OECD's guidance may prove to be useful in terms of providing possible interpretations of certain transfer pricing issues also in the USA, despite its non-binding character.<sup>194</sup>

The following sections deal with certain transfer pricing provisions in more detail and to the extent necessary for examining the research object, the transfer pricing of business restructurings. The provisions will form the basis for the forthcoming sections discussing the question whether, and to what extent, business restructurings may fall within the scope of transfer pricing regulations in Russia, Finland and the USA.

### **2.2.3 TRANSACTION TYPES FALLING WITHIN THE SCOPE OF TRANSFER PRICING PROVISIONS**

National transfer pricing provisions may define the transaction types that fall within the scope of transfer pricing rules, which must therefore comply with the requirements of the arm's length principle. According to Article 105.14 of the Russian Tax Code, the transfer pricing provisions shall be applied primarily to controlled transactions (in Russian: *kontroliruemye sdelki*), defined as transactions conducted between related parties. Such controlled transactions, i.e. related party transactions, may be cross-border transactions as well as intrastate, domestic transactions, although the transfer pricing provisions shall be applied to the latter only if the total amount of profits derived from domestic transactions exceeds one billion rubles during the financial year or if other specific conditions are met.<sup>195</sup> The most noteworthy issue is that, according to the Tax Code, the transfer pricing rules shall be applied only to controlled transactions involving transfers of *commodities, services and/or work*. The Tax Code does not mention, for example, loans and intangibles at all. Pursuant to Article 105.14 of the Tax Code, inter alia, cross-border transactions involving goods traded on foreign commodities

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<sup>193</sup> Madrian – Weise 2014, pp. 756–759; Zollo 2011, p. 760; Feinschreiber 2004, p. 206. See also Wittendorff 2011, p. 227.

<sup>194</sup> As discussed, in general, the OECD member states are encouraged to follow the guidelines, although they are not legally binding; see OECD Transfer Pricing Guidelines, Preface, 15–17, and e.g. Gelin – Lubick – Ossard-Quintaine 2014, pp. 70–71.

<sup>195</sup> See Article 105.14 of the Tax Code in more detail.

exchanges,<sup>196</sup> as well as transactions with residents of the so-called black-listed jurisdictions (as defined by the Minfin), are comparable to the controlled transactions under certain circumstances, although such transactions have been executed by independent parties.

As was the case in Russia, the Finnish transfer pricing provisions are applied to related party transactions, which may by nature be strictly domestic or cross-border transactions.<sup>197</sup> Nevertheless, the approach taken by the Tax Code differs from the approach taken by Finnish law, as pursuant to § 31 of the AAP, the transfer pricing provisions shall be applied to all type of transactions performed between related parties, without imposing any special conditions on the nature of the transactions or objects thereof.<sup>198</sup> These kinds of transactions may be general sale and purchase activities as well as, inter alia, transfers of intangible assets and gratuitous arrangements.<sup>199</sup>

In the USA, the transfer pricing rules are similarly applied to related party transactions, which are either domestic or cross-border transactions. The types of transactions, which fall within the scope of U.S. transfer pricing regulations, have not been limited to a particular type of transaction (e.g. concerning only tangible assets, services etc.). According to Section 482 of the IRC, “-- the Secretary may distribute, apportion, or allocate gross income, deductions, credits, or allowances between or among such [controlled] organizations, trades, or businesses, if he determines that such distribution, apportionment, or allocation is necessary in order to prevent evasion of taxes or clearly to reflect the income of any of such organizations, trades, or businesses --.” On the other hand, Section 482 specifically mentions transfers (or licenses) of intangible properties as objects falling within its scope. Nevertheless, Section 482 is considered applicable to all kinds of related party transactions; Treasury Regulations, for example, specifically regulate the transfers of tangible and intangible assets as well as transfers of services.<sup>200</sup>

In contrast to the Russian transfer pricing provisions, the scope of application of the transfer pricing provisions is broader in Finland and the USA. This difference may seem insignificant, but it turns out to be a great problematic question in the business restructuring context, as restructurings commonly involve, in addition to transfers of goods and services, transfers of intangible assets between controlled parties. As the Tax Code is silent in this regard, it is not entirely clear if Russian transfer pricing provisions should be applied to,

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<sup>196</sup> For instance, transactions involving oil, oil products as well as ferrous and non-ferrous metals.

<sup>197</sup> HE 107/2006 vp, p. 20.

<sup>198</sup> Similarly has been regulated in Article 9 of the OECD Model Tax Convention.

<sup>199</sup> HE 107/2006 vp, p. 20.

<sup>200</sup> See Treas. Reg. § 1.482-3, § 1.482-4 and § 1.482-9.

for instance, transfers of intellectual property rights or goodwill in the course of business restructurings. Fortunately, the Minfin and the FTS have provided additional guidance in this regard, which will be dealt with in more detail in Chapter 3 of this study.

## **2.2.4 RELATED PARTY TRANSACTIONS**

As it was mentioned above, the transactions falling within the scope of application of the transfer pricing rules must be the so-called *related party transactions (or controlled transactions)*, or otherwise they fall outside the scope.<sup>201</sup> Therefore, how the concept of related parties is defined by the national laws of Russia, Finland and the USA must be discussed.

Article 105.1 of the Russian Tax Code comprehensively regulates conditions under which companies are considered related parties (in Russian: *vzaimozavisimye lica*).<sup>202</sup> As a general rule, the parties are regarded as related parties, when the relationship between the parties has specific features which may affect the terms and conditions of the transaction or the commercial result of the transaction. For instance, the parties are considered related parties, when one party holds, directly or indirectly, more than 25 per cent of the capital of another party (company). In addition, a transaction is deemed to be a related party transaction, when a mutual parent company owns, directly or indirectly, more than 25 per cent of the capital of both parties to the transaction.

Pursuant to Article 105.1 of the Tax Code, other related party transaction types are, inter alia, transactions between two parties, where one party has the power to appoint the managing director or at least 50 per cent of another party's members of the board of directors or the supervisory board; where the same (third) party has appointed the managing director of both parties or at least 50 per cent of both parties' members of the board of directors or the supervisory board; or where more than 50 per cent of the members of the board of directors or the supervisory board of both parties consists of the same individuals or their close relatives. It is particularly important to note that a court may also deem parties to be related parties on other grounds than those listed in Article 105.1 of the Tax Code, provided that the relationship between

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<sup>201</sup> Except for transactions defined in more detail in the Tax Code, involving transfers of certain commodities (e.g. oil) or performed under certain exceptional circumstances, as mentioned in the previous section.

<sup>202</sup> The article contains in total over ten different examples of circumstances, in which parties to a transaction are deemed to be related parties. Only the most relevant situations are discussed herein.

the parties has such specific features that may have an effect on the terms or the result of the transaction.

The Tax Code's provision is largely comparable to the Finnish provision regulated under § 31.2 of the AAP, but the former provision is more detailed and has a broader scope of application. According to § 31.2 of the AAP, the parties to a transaction are regarded as related parties if one party has control over another party or if a third party, alone or together with related entities/parties, has control over both parties. Pursuant to § 31.2 of the AAP, a party may have control over another party, when: (i) it holds, directly or indirectly, more than 50 per cent of the capital of another party; (ii) it has, directly or indirectly, more than 50 per cent of the total number of votes generated by all the shares of another party; (iii) it has, directly or indirectly, the right to appoint more than 50 per cent of the members of the board of directors of another party or similar organ; or (iv) a party has control over another party through joint control with a third party or other type of actual control.

Section 482 of the IRC concerns controlled organizations, trades and businesses (i.e. taxpayers).<sup>203</sup> The controlled transactions, in other words related party transactions, require that two or more parties participating in the transaction are owned or controlled by the same interests. The term "controlled" is defined very broadly, as it covers any kind of control, both direct and indirect control, "-- whether legally enforceable or not, and however exercisable or exercised, including control resulting from the actions of two or more taxpayers acting in concert or with a common goal or purpose --." The form of the control is not crucial, when the existence of control is examined; the reality of the control matters the most. In addition, the Treasury Regulations contain an assumption of control in situations where income or deductions have been "arbitrarily shifted."<sup>204</sup> When two group companies execute a transaction, and one of the companies is wholly owned by the other party — parent company — or both parties are wholly owned by the same parent company, there is no ambiguity in whether the transaction is a controlled transaction.<sup>205</sup> In case law, transactions have often been deemed controlled transactions if a party has owned the majority or at least 50 per cent

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<sup>203</sup> These concepts have been defined in the Treasury Regulations, see Treas. Reg. § 1.482-1(i)(1)–(2). See also Wittendorff 2010a, pp. 63–64.

<sup>204</sup> Treas. Reg. § 1.482-1(i)(4).

<sup>205</sup> Levey – Wrappe – Chung 2006, p. 4.

of the stock of another party, although this has not been satisfactory in some cases.<sup>206</sup>

Pursuant to Russian law, parties to a transaction are considered related parties, and the transactions correspondingly as controlled/related party transactions, already when one party holds directly or indirectly more than 25 per cent of the capital of another party, whereas the corresponding requirement for the share under Finnish law is more than 50 per cent. The legal situation in the USA is in this respect more similar to the situation in Finland than Russia; although the concept of control has been defined more broadly in the Treasury Regulations, case law has in practice required ownership of at least 50 per cent in another party. From this perspective, the threshold for considering transactions as related party transactions is lower in Russia when compared to the current legal situations in Finland and the USA. Consequently, transactions conducted between group companies fall more likely within the scope of transfer pricing regulations in Russia.

## **2.2.5 ARM'S LENGTH PRINCIPLE**

As discussed, the arm's length principle is nowadays regulated in the Tax Code and is therefore the guiding principle in Russian transfer pricing. According to Article 105.3 of the Tax Code, if related parties use in their transactions commercial or financial terms and conditions, which differ from the terms and conditions used by non-related parties in comparable transactions under similar conditions, a related party's tax base may be increased for income taxation purposes. The arm's length principle regulated in Article 105.3 of the Tax Code is to a great degree equivalent to the earlier discussed Article 9 of the OECD Model Tax Convention.

The arm's length principle is regulated in Finland under § 31 of the AAP. Pursuant to § 31 of the AAP, in case in a transaction between a taxpayer and a related party has been agreed on or imposed terms that deviate from the terms that would have been agreed on between independent parties and, as a result, the taxpayer's income subject to taxation is less or the taxpayer's loss is more than what it would have otherwise been, an amount, which would have accrued if the parties would have used the terms and condition independent parties would have used, shall be added to the taxable income. According to the preliminary works, the provision embodies the arm's length principle.<sup>207</sup>

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<sup>206</sup> See *B. Foreman Co. Inc. v. Commissioner*, 72-1 USTC 9182, 453 F. 2d 1144 (2nd Cir. 1972) and *R.T. French Co. v. Commissioner*, 60 T.C. 836 (1973). See more about the concept of controlled parties and related case law in Gazur 1994, pp. 17–73.

<sup>207</sup> HE 107/2006 vp, p. 20.

Pursuant to the Finnish Tax Administration's guidance, the provision must be interpreted in accordance with the principles of the OECD Transfer Pricing Guidelines.<sup>208</sup> Therefore, it is safe to state that the arm's length principle under Finnish law corresponds to the arm's length principle regulated by the OECD in its Model Tax Convention and the guidelines.

The arm's length principle is understood as the concept of *arm's length standard* in the USA. The primary sources of the arm's length standard are Section 482 of the IRC and the related Treasury Regulations. As mentioned above, pursuant to Section 482 of the IRC, "-- the Secretary may distribute, apportion, or allocate gross income, deductions, credits, or allowances between or among such [controlled] organizations, trades, or businesses, if he determines that such distribution, apportionment, or allocation is necessary in order to prevent evasion of taxes or clearly to reflect the income of any of such organizations, trades, or businesses --." In comparison with the similar provisions of Russian and Finnish law, Section 482 does not set the terms and conditions of a related party transaction against the terms and condition of transactions conducted between uncontrolled parties.

On the other hand, the Treasury Regulations bring clarity in this regard. According to the Treasury Regulations, the arm's length standard is used in determining a true taxable income of a taxpayer. The arm's length standard is met by the taxpayer, if the results of the controlled transaction are in line with the results that would have realized if uncontrolled parties would have conducted the same transaction under the same conditions.<sup>209</sup> As it is often almost impossible to find the exactly same transactions to which the taxpayer could refer, the examination of whether the results of the related party transaction are arm's length can be done by comparing the results to the results of comparable uncontrolled transactions under similar conditions.<sup>210</sup>

All in all, the concept of the arm's length principle — or the arm's length standard — is to a large extent regulated comparably in Russia, Finland and the USA. Nevertheless, the national provisions relating to the application of the arm's length principle in practice, for instance the regulations concerning the transfer pricing methods as well as documentation and notification requirements, also have their own peculiarities. These regulations and differences will be discussed in more detail in the forthcoming chapters of this research.

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<sup>208</sup> Finnish Tax Administration Memorandum 1471/37/2007, p. 4.

<sup>209</sup> When the results meet the requirements of the arm's length standard, the results are called *arm's length results*.

<sup>210</sup> Treas. Reg. § 1.482-1(b)(1).

## 3 OBJECTS OF TRANSFER PRICING IN BUSINESS RESTRUCTURINGS

### 3.1 GENERAL

Business restructurings usually involve transfers of something of value, such as tangible and intangible assets, from one controlled party to another. If such items of commercial value would be transferred in transactions conducted between independent parties, a market based compensation would be paid for their transfer. The arm's length principle requires that related parties should, in a similar manner, compensate such transfers at arm's length, i.e. using similar commercial and market based terms that independent parties would use under similar conditions, provided that the national transfer pricing rules are applicable to such transfers.

The transfer pricing of business restructurings may be considered a two-step process. The first step involves the above-mentioned identification of something of value that is/are transferred during a business restructuring between related parties and the examination of whether transfers of such assets and other items of commercial value (something of value) will fall within the scope of application of the national transfer pricing provisions. For example, some national transfer pricing rules may limit the scope of transactions to which the transfer pricing rules — including the arm's length principle — may be applied, as was the case with the Russian Tax Code discussed briefly above. The determination of arm's length compensations for transfers falling within the scope of national transfer pricing rules in the business restructuring context forms the second step.

In this chapter, the aforementioned first step is explored in detail, examining to what extent business restructurings may be subject to transfer pricing pursuant to the Russian, Finnish and U.S. transfer pricing regulations. In particular, whether the types of assets and something of value, which are frequently transferred in business restructurings, fall within the scope of application of the transfer pricing provisions of Russia, Finland and the USA in the above-mentioned manner is discussed. Hence, this chapter primarily reviews the first primary research question, i.e. what are *the objects* of transfer pricing in cross-border business restructurings. In the beginning of this chapter, examples of business restructurings are explored in order to demonstrate what kinds of assets and other items of commercial value may be transferred in business restructuring in general, after which possible objects of transfer pricing are dealt with on a case-by-case (or an asset-by-asset) basis. The second research question — how to determine actual arm's length



compensations for transactions occurring in the course of business restructurings — will be discussed in Chapter 4.

The choice to examine the applicability of the transfer pricing rules to transfers of certain items of value and, consequently, to examine them as possible objects of transfer pricing herein is largely based on Chapter IX of the OECD Transfer Pricing Guidelines and the discussed topics therein. As typical transfers of something of value in business restructurings, the guidelines mention individual transfers of tangible assets and intangible assets as well as transfers of an ongoing concern.<sup>211</sup> Furthermore, the guidelines discuss, in this connection, the reallocation of risks (and related profit potential) and possible termination or renegotiation of existing agreements during business restructurings.<sup>212</sup> As the following examples of business restructurings show, these kinds of transfers of something of value also generally occur in business restructurings, which supports this approach. Hence, taking also into consideration the remarkability of the OECD Transfer Pricing Guidelines in practice, it is reasonable and validated to follow the guidelines in this respect.<sup>213</sup> Moreover, this approach allows the examination of whether transfers of assets/items of value can be analyzed and valued on an aggregate basis (i.e. as a going concern) in transfer pricing of business restructuring or whether such an analysis must be conducted only on an asset-by-asset basis. The question is of great interest in business restructurings, since not all countries allow the aggregation of related party transactions in this sense.<sup>214</sup>

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<sup>211</sup> OECD Transfer Pricing Guidelines, 9.48.

<sup>212</sup> OECD Transfer Pricing Guidelines, 9.43 and 9.75. It is noteworthy to observe that the OECD also very briefly mentions the question of “outsourcing” in connection with its analysis of compensating transfers of something of value in business restructurings, see OECD Transfer Pricing Guidelines, 9.74. Given the limited presentation of the question also by the OECD and that outsourcing as such cannot likely be regarded as an object of transfer pricing (see the mentioned paragraph), it has also been excluded from the scope of this research. This view is also justified from the perspective of that one of the main questions that may arise in outsourcing is the allocation of the so-called location savings; see OECD Transfer Pricing Guidelines, 1.140–1.143, 9.74. As they are usually taken into account in a comparability analysis (not as objects of transfer pricing), and in business restructurings they concern post-restructuring transactions (which are not in the scope of this research), the aforementioned approach is validated also from this perspective; see OECD Transfer Pricing Guidelines, 9.126–9.131. See also KHO 2013:36.

<sup>213</sup> This can be validated also with a reference to legal literature where the mentioned asset types/items of value have similarly been reviewed in connection with business restructurings; see e.g. Kroppen – Silva 2011, pp. 32–49.

<sup>214</sup> See Kroppen – Silva 2011, pp. 42–45.

## 3.2 EXAMPLES OF BUSINESS RESTRUCTURINGS

Traditionally, business restructurings have involved different types of changes in a multinational enterprise's manufacturing, distribution or IPR-related activities. In recent years, these traditional ways of changing business models have been followed by more complex variations and alternatives.

A group's manufacturing operations can be enhanced by moving from conventional manufacturing into contract manufacturing. When a group company is engaged in traditional manufacturing operations, the company owns the fixed assets used in the manufacturing, as well as the raw materials and the finished commodities. It also coordinates of the procurement of raw materials, manufacturing of the products and sending the finished products to the distribution entities. Consequently, it is responsible for various risks, including inventory, guarantee, exchange rate and credit risks.<sup>215</sup> The group company basically bears all the risks involved in the manufacturing process, which is why it is usually called a fully-fledged manufacturer.

Contract manufacturers make a product for a principal company pursuant to a specific agreement concluded between the parties. A contract manufacturer primarily owns the raw materials and fixed assets used in manufacturing as well as bears the risks related thereto as well as to manufacturing activities. In general, the contract manufacturer takes the title to the finished products and bears the associated risks, although sometimes these may be allocated to the principal; nevertheless, the principal does not bear the risks relating to the actual manufacturing of products. The purest form of contract manufacturing is toll manufacturing, where the principal has also the title to raw materials and assumes risks associated with such raw materials, meaning that the manufacturing company takes care only of the manufacturing process itself.<sup>216</sup>

Manufacturing activities of group companies have been conventionally located in countries, which have a high tax rate. When a traditional manufacturing business model based on a fully-fledged manufacturer is amended to a contract manufacturing model, the principal company will usually be based in a country with a low effective tax rate and a contract manufacturer will be left with only minimal risks in the country with a higher tax rate. In such a conversion, the principal bears the majority of the risks involved in the manufacturing and the contract manufacturer's compensation is reduced to the level appropriate for low-risk manufacturing activities, which results in

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<sup>215</sup> Engblom et al. 2010, p. 548 and Russo 2007, pp. 183–184. For instance, the inventory risk refers to the risk that stored products are damaged or lost from a company's warehouse; see e.g. Finnish Tax Administration Memorandum 1471/37/2007, p. 25.

<sup>216</sup> Van Herksen 2009, pp. 19–24; Russo 2007, p. 184.

that only a part of the income will be subject to taxation in a country with a high tax rate. Consequently, more profits will be taxed in the country with a lower rate, i.e. where the principal is located.<sup>217</sup>

When the aforesaid conversion from a fully-fledged manufacturer to a contract or toll manufacturer is made, something of value may be transferred from one jurisdiction to another. For instance, the raw material and fixed assets, such as machinery, may be transferred to the new manufacturer located in another jurisdiction. This may also involve risks associated with the restructured manufacturing activities and even whole functions are transferred and reallocated between group companies.<sup>218</sup> From the transfer pricing perspective, in such business restructurings it must be examined whether transfers of these kinds of items of commercial value may be objects of transfer pricing pursuant to the national transfer pricing regulations.

Changing the conventional manufacturing model into a contract or toll manufacturing model is not always sufficient, when a multinational enterprise is aiming at improving overall performance within the group. The development of the group's distribution functions may also be one of the objectives behind business restructurings. When a distributor acts as a fully-fledged distributor, in addition to taking care of all usual distribution activities — such as, importing, advertising, managing of the inventory as well as delivering and selling the products — it bears all the risks associated with such functions. The risks comprise, among other things, inventory risk, market risk, exchange rate risk and credit risk. The fully-fledged distributor potentially earns a (higher) remuneration, which corresponds to the high level of risks it assumes.<sup>219</sup>

When business restructurings are targeted at making the distribution models more tax efficient, this usually means that a fully-fledged distributor is changed into a limited-risk distributor. In a limited-risk distributor model, the distributor concentrates on its main task, selling the products to customers, then some of the tasks and risks of a traditional distributor are assumed by a principal company located in another country. In this model, the distributor may, among other things, buy the products from the principal just before selling them to customers, or the principal may be liable to buy the products back from the distributor at certain cost if there has not been great demand for the products. One form of a limited risk distribution model is a traditional buy-

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<sup>217</sup> Miall 2007, p. 15; Russo 2007, pp. 184–186; Engblom et al. 2010, pp. 550–551.

<sup>218</sup> Van Herksen 2009, pp. 41–42; OECD Transfer Pricing Guidelines, 9.49–9.51.

<sup>219</sup> Kroppen – Silva 2011, p. 54; Miall 2007, p. 17; Russo 2007, p. 194; Engblom et al. 2010, p. 566. Market risk, for example, means that a company is not able to sell the finished products at a profit – or at all, see e.g. Finnish Tax Administration Memorandum 1471/37/2007, p. 25.

sell model, where a group company acting as a distributor buys the commodities from another group company and sells them to local customers. Although the classic buy-sell distributor usually has the title to the products to be sold, some core functions and risks — such as, the inventory of products and risks thereof — have been removed from the buy-sell distributor. This arrangement leads to the low-risk distributor receiving a remarkably lower profit than it would have received as a fully-fledged distributor due to the fact that it does not bear all the relevant risks involved in the distribution activities.<sup>220</sup> When a principal company is located in a country with a low tax rate and a low-risk distributor is located in a country with a high tax rate, the change from a traditional fully-fledged distribution model to low-risk model forms a tax efficient end result.

A fully-fledged distribution model may also be converted to an agency model or commissionaire model. In the agency model, a local distributor works as an agent for a foreign group company and sells the products to customers on behalf of the foreign principal. As the agent does not have the title to the products, it bears only moderate risks, while the foreign group company bears the majority of the risks. In a commissionaire model, a distributor acting as a commissionaire has similarly concluded an agency agreement with a foreign group company. However, when the commissionaire concludes sales agreements with customers, it does so under its own name, not on behalf of the foreign principal. This means that the principal and the customer have no contractual obligations towards each other. Nevertheless, like in the agency model, the products are actually sold for the benefit of the undisclosed principal, which, for instance, holds the stock of commodities as well as assumes the main risks relating to the distribution, while the commissionaire bears only minimal risks. Both models enable multinational groups to plan that the majority of the profits derived from the distribution activities are realized in jurisdictions with a low effective tax rate.<sup>221</sup>

The conversions from a fully-fledged distribution model to low-risk distribution models may in practice involve that some assets, for example inventories of goods, are transferred between group companies to execute the new distribution model. Furthermore, certain functions and associated risks are likely to be transferred in such cases in the above-mentioned manner.<sup>222</sup> As the transfers are conducted between related parties, the arm's length principle must primarily be applied to such transfers, provided that they fall within the scope of application of transfer pricing provisions.

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<sup>220</sup> Hopkins 2007, p. 7; Russo 2007, pp. 195–196; Van Herksen 2009, pp. 29–31.

<sup>221</sup> Engblom et al. 2010, pp. 567–568; Russo 2007, pp. 195, 197–200.

<sup>222</sup> Van Herksen 2009, pp. 43–44.

Apart from manufacturing and distribution activities, a business restructuring may be aimed at amending a multinational group's centralized functions and activities related to, *inter alia*, intellectual property rights. Traditionally a company, which is involved in intellectual property rights development, carries out the research and development (R & D) work related to its business as well as bears all the expenses and risks associated with it. On the other hand, such a company will hold the title to the intellectual property rights that will arise from such R & D activities. In particular, the business restructuring's objective may be the centralization of the group's intellectual property rights in one group company, i.e. "IP company". For example in a contract R & D model, all the intangible assets of a group are set to be owned by a particular IP company, which in turn concludes agreements with subsidiaries regarding R & D activities. Such subsidiaries perform R & D activities on behalf of the IP company against a fee, while the IP company assumes the economic risks in relation to R & D activities, e.g. unsuccessfulness of the R & D work, and receives the ownership to the possible end results of the R & D activities. As the IP company bears the main financial risks, the R & D company is not entitled to a significant margin from its R & D work.<sup>223</sup>

Other variant may be that both intellectual property rights and R & D activities are centralized in one group company. This IP company will own all the present intellectual property rights and intangibles of the group as well as any future intellectual property rights and intangibles, which arise from its own R & D activities. In this arrangement, the IP company enters into licensing agreements with other group companies. As the subsidiaries are granted the right to use the IP company's intellectual property rights, the IP company is entitled to royalties.<sup>224</sup>

In general, it is usually more tax efficient that the group's intellectual property rights and other intangibles are located in a jurisdiction with a low effective tax rate; in that case, the profits generated through intellectual property rights would be subject to low income tax. However, one issue, which may also have an effect in this regard, is the maximization of the deductibility of the expenses resulting from the R & D activities. If the intellectual property rights will be owned by a company located in a low tax rate country, the deductibility for the expenses will also be at the same low rate; *vice versa*, if intellectual property is owned in a jurisdiction with a high effective tax rate, the expenses can also be deducted at a higher rate. In addition, many non-taxation related issues

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<sup>223</sup> Russo 2007, p. 172; Engblom et al. 2010, p. 562. See also Vardaman 1998, pp. 28–30 and Lev 2001, pp. 55–62. Especially the latter deals with contract R & D model in more detail.

<sup>224</sup> Kroppen – Silva 2011, p. 57.

may also have an impact on where the intellectual property rights would be rational to locate.<sup>225</sup>

Nevertheless, from the point of view of transfer pricing, business restructurings consisting of conversions of intellectual property strategies of multinational enterprises very likely result in cross-border transfers of intangible assets between group companies. Consequently, as intangible asset transfers are generally remunerated in transactions between unrelated parties, such transfers should be remunerated also in related party transactions in accordance with the arm's length principle provided that such intangible asset types are in the scope of national transfer pricing regulations.

In addition to the above-mentioned ways of changing a multinational enterprise's business models (i.e. amendments concerning manufacturing and distribution activities as well as intellectual property rights management), business restructurings may be directed at other, perhaps more specifically restricted, business sectors of the group. For example, restructurings may relate to establishing specific procurement companies, which manage the procurement of raw materials within the whole group instead that the manufacturing companies or contract manufacturers would take care of it independently.<sup>226</sup> Furthermore, the newest types of business models involve the centralization of particular services of the group in one specific group company. This may mean that, among other things, the marketing, IT support or HR services of the group companies are located in one group company, which also assumes all the liabilities and risks related to such activities.<sup>227</sup> By implementing these kinds of business model changes, multinational enterprises may achieve remarkable tax and other savings. On the other hand, such amendments usually lead to something of value (such as, intangible property) being transferred within the group, in which case it must be examined should the transfer pricing provisions be applied — and to what extent — to such transfers.

The aforementioned types of amending business models provide examples of how business restructuring may be executed in practice and what kinds of assets and something of value may be transferred between controlled parties in the business restructuring context. The purpose was not to provide an all-embracing description of all the possible means of amending a group's business models, as the business restructurings often have their own peculiarities, which must be taken into consideration. Furthermore, the

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<sup>225</sup> Russo 2007, pp. 171–174. One of the non-taxation considerations is how well the intellectual property rights are legally protected in the country in question.

<sup>226</sup> Irving – Kilponen – Markarian – Klitgaard 2005, p. 59; Webber 2011, pp. 163–165.

<sup>227</sup> Wright 2006, p. 202.

conditions under which business restructurings are implemented usually vary.<sup>228</sup>

### 3.3 FUNCTIONAL ANALYSIS

In order to examine to what extent business restructurings fall within the scope of transfer pricing rules in Russia, Finland and the USA, how different types of transfers of assets and something of value occurring in the course of a business restructuring could be identified for transfer pricing purposes must be discussed. The identification of transfers of assets and something of value in business restructurings relates to identifying the actual transactions executed during a business restructuring. For example, according to the OECD Transfer Pricing Guidelines, the accurate delineation of the transactions performed during the business restructuring is an essential part of the transfer pricing process of business restructurings as it precedes the aforementioned second step, the determination of the arm's length compensation, which shall be paid to a related party as a result of transferring something of value in the business restructuring. The accurate delineation of related party transactions occurred in the business restructuring comprises the performance of a *functional analysis*, which aims to identify all the "economically significant activities and responsibilities undertaken, assets used or contributed, and risks assumed" by the restructured entity and other group companies involved in the business restructuring, both before and after the restructuring.<sup>229</sup> The functional analysis helps the parties to understand the whole structure of the business restructuring and, in particular, what kinds of transactions have been performed in the course of a business restructuring.

The above-mentioned accurate delineation of transactions as well as the identification and analysis of transactions and activities of related parties by performing a functional analysis are not limited only to the transfer pricing of business restructurings, but must be in general performed in all transfer pricing cases.<sup>230</sup> Hence, it is no surprise that the functional analysis and performance thereof is often regulated also in national transfer pricing legislation and rules. As these general functional analysis provisions are applied to all transfer pricing issues, they must also be naturally applied to business restructuring transactions.

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<sup>228</sup> For instance, in Russia, the transfer pricing aspects of business restructuring may become a particularly topical question for companies operating in the oil and gas industry, as such companies form the majority of companies dealing with transfer pricing questions in practice in Russia, see more in Kasatkin 2004, p. 8.

<sup>229</sup> OECD Transfer Pricing Guidelines, 9.15–9.18.

<sup>230</sup> See OECD Transfer Pricing Guidelines, 9.15, 9.18 and Section D.1 of Chapter I.

In Russia, the Tax Code's transfer pricing provisions regulating the functional analysis (in Russian *funktsional'nyj analiz*) are included in the section, which deals with the *comparability analysis*. The comparability analysis in principle means the comparison of the terms and conditions of a controlled transaction to the terms and conditions of a comparable transaction conducted between independent parties under similar circumstances in order to examine whether the controlled transaction complies with the arm's length principle (i.e. whether the compensation paid in the controlled transaction is arm's length).<sup>231</sup> According to the Tax Code, when deciding whether transactions are comparable and/or whether the pricing used in a controlled transaction must be adjusted, it must be analyzed what kinds of functions the parties to a controlled transaction have performed; what kinds of assets they have possibly used in the transaction; whether the parties have assumed any risks in the transaction; how the liabilities have been allocated between the parties; as well as any other similar terms and conditions of the transaction. Such an analysis forms the functional analysis.<sup>232</sup>

The functional analysis must be documented by taxpayers as it forms a part of the transfer pricing documentation. The FTS has published a letter concerning the requirements of transfer pricing documentation, which also includes recommendations on the documentation of the functional analysis.<sup>233</sup> According to the letter, the FTS recommends characterizing the function types/profiles of the companies participating in the related party transaction, i.e. whether the companies are, by nature, commissionaires, fully-fledged distributors or limited-risk distributors.<sup>234</sup> The characterization of such business types with different risks before and after controlled transactions helps related parties to understand what has occurred in the transactions. Despite the fact that business restructurings have not been specifically mentioned in the Tax Code's provisions, it is evident that Article 105.5 of the Tax Code must also be applied to business restructurings due to its general nature.

In Finland, the functional analysis (in Finnish *toimintoarviointi*) is also a part of the transfer pricing documentation, which must be prepared on an annual basis by the related parties having concluded controlled transactions, and

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<sup>231</sup> As discussed, the determination of arm's length compensation in the business restructuring context, including the comparability analysis, will be discussed in more detail in Chapter 4 of this study.

<sup>232</sup> Article 105.5 of the Tax Code.

<sup>233</sup> Pis'mo Federal'noj nalogovoj sluzhby Rossii ot 30.08.2012 N OA-4-13/14433@ "O podgotovke i predstavlenii dokumentatsii v tselyakh nalogovogo kontrolya."

<sup>234</sup> It must be observed that the letter introduced and recognized for the first time in Russian tax law the characterization of companies by their functions and risks.



which must be presented to the tax authorities on their request.<sup>235</sup> The functional analysis has not been regulated in detail in the Finnish legislation; § 14 b of the AAP simply states that the transfer pricing documentation must comprise, among other things, a functional analysis on transactions performed between related parties as well as between a company and its permanent establishment.

According to the preliminary works, the concept of functional analysis referred to in § 14 b of the AAP relates to the concept of functional analysis regulated in the OECD Transfer Pricing Guidelines, meaning a description and analysis of the functions of related parties taking into account the assets used and the risks assumed. The functional analysis should be prepared for both of the parties to a related party transaction.<sup>236</sup> As the functional analysis should be understood with the same meaning as discussed in the OECD Transfer Pricing Guidelines, more detailed guidance with regard to performing the functional analysis can be found from the OECD Transfer Pricing Guidelines. Pursuant to the OECD Transfer Pricing Guidelines, the functional analysis as such means, in the above-mentioned sense, the examination of functions that have been performed (taking into consideration also the assets used and risks borne) in a controlled transaction. The functional analysis aims at identifying the activities of economic importance as well as responsibilities undertaken, assets used or contributed and risks assumed by the related parties. The functional analysis is insufficient, if the material risks assumed by the parties have not been identified and described in the analysis.<sup>237</sup> The functional analysis is one of the five factors to be considered, when performing a comparability analysis.<sup>238</sup>

The Finnish Tax Administration has similarly confirmed in its memorandum that the functions performed in a related party transaction must be described in the functional analysis, also taking into account the assets used and the risks assumed. Interestingly, the Finnish Tax Administration specifically mentions that the functional analysis is of great relevance in business restructurings. Business restructurings usually result in that functions and/or assets and risks of a group company are transferred to another group entity. Therefore, the

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<sup>235</sup> § 14 a–14 c of the AAP. See also Section 5.3 of this research, where the transfer pricing documentation requirements are discussed in more detail.

<sup>236</sup> HE 142/2016 vp, p. 10; HE 107/2006 vp, p. 15.

<sup>237</sup> OECD Transfer Pricing Guidelines, 1.51–1.52, 1.56. The OECD Transfer Pricing Guidelines' provisions regarding functional analysis (Chapter I, Section D.1.2) are quite new as Chapter I, Section D of the OECD Transfer Pricing Guidelines was deleted in its entirety and replaced by totally new provisions as a result of the OECD's BEPS Project. Especially the importance of risks is highlighted in the new provisions; see OECD BEPS Actions 8–10, pp. 13–14.

<sup>238</sup> OECD Transfer Pricing Guidelines, 1.36.

functional analysis means in the business restructuring context that the following must be described: what kinds of changes have occurred in the performed functions of the related parties taking into consideration the assets used and risks assumed in such functions. The functional analysis must be performed before and after the execution of the business restructuring.<sup>239</sup>

Nonetheless, Russia is not an OECD member state, the functional analysis as a concept as well as its content are to a great degree equivalent to the OECD Transfer Pricing guidelines and hence Finnish law. Under both countries' laws, the functional analysis consists of an evaluation of the functions of related parties in a controlled transaction, covering also the assets used and risks assumed by the parties in connection with the transaction. Both countries have also specifically published guidance in relation to characterizing changes in different business function types (Russia) or even in the business restructuring context (Finland), which provides useful help to understand business restructurings and identify transfers of something of value occurred therein.

The functional analysis under U.S. tax law is regulated in the Treasury Regulations. As was the case with Russian law and the OECD Transfer Pricing Guidelines, the functional analysis forms a part of the comparability analysis also in the U.S. transfer pricing. According to § 1.482-1(d)(1) of the Treasury Regulations, "whether a controlled transaction produces an arm's length result is generally evaluated by comparing the results of that transaction to results realized by uncontrolled taxpayers engaged in comparable transactions under comparable circumstances." One of the comparability factors to be taken into consideration in the comparability analysis is functions.<sup>240</sup>

Pursuant to § 1.482-1(d)(3)(i) of the Treasury Regulations, the functional analysis under U.S. law relates to determining the comparability between controlled and uncontrolled transactions by comparing the functions performed, and associated resources used, by parties to such transactions. The functional analysis "identifies and compares the economically significant activities undertaken, or to be undertaken, by the taxpayers in both controlled and uncontrolled transactions." In this sense, the functional analysis should contain a consideration of the resources employed, or to be employed, in connection with such activities, comprising a consideration of the types of assets that are used (e.g. intangibles). The Treasury Regulations expressly identify certain functions that may need to be accounted for in the functional analysis. These functions include, among other things, R & D, manufacturing,

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<sup>239</sup> Finnish Tax Administration Memorandum 1471/37/2007, pp. 23 and 25–26.

<sup>240</sup> See Treas. Reg. § 1.482-1(d)(1) and § 1.482-1(d)(3).

production and process engineering, as well as marketing and distribution functions.<sup>241</sup>

The Treasury Regulations do not directly state that the functional analysis should also include a description of risks assumed by the parties in connection with the functions and activities. However, risks form one of the comparability factors, which means that they must be taken into account separately in the comparability analysis.<sup>242</sup> The Treasury Regulations thus deviate from the OECD Transfer Pricing Guidelines – as well as from the Finnish and Russian transfer pricing rules – in this respect. Nevertheless, the difference has been regarded as strictly formal and technical.<sup>243</sup> In addition, according to the IRS's Internal Revenue Manual, a risk analysis should be performed in conjunction with the functional analysis.<sup>244</sup> As the functional analysis under U.S. law concentrates on the examination of the functions performed (or to be performed) by the parties, taking into account resources and assets employed, it is broadly consistent with the Finnish and Russian provisions and the principles of the OECD Transfer Pricing Guidelines. It must also be observed that, similar to the FTS's guidance as regards functional analysis in Russia, the Treasury Regulations identify different kinds of functions or activity types that should be considered when performing the functional analysis.

The functional analysis may be generally perceived by taxpayers as a great burden related to complying with the transfer pricing documentation requirements. Nonetheless, as the functional analysis involves the examination of the changes in the related companies' functions as well as associated assets and risks, it forms an excellent tool to identify transactions and – more importantly – transfers of something of value occurred in related party transactions. It must be highlighted that in business restructurings the functional analysis is especially of practical importance, as it is generally very ambiguous to what extent a business restructuring may fall within the scope of the national transfer pricing regulations and be an object of transfer pricing. As the functional analysis helps related parties to identify the controlled transfers of assets and something of value also in the business restructuring context, a functional analysis should always be done thoroughly and in a diligent manner in business restructurings both before and after the restructuring. A successfully performed functional analysis is one step closer to a successful transfer pricing of a business restructuring.

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<sup>241</sup> Treas. Reg. § 1.482-1(d)(3)(i).

<sup>242</sup> Treas. Reg. § 1.482-1(d)(3)(iii).

<sup>243</sup> Feinschreiber 2004, p. 212.

<sup>244</sup> Section 4.61.3.5.3 of the Internal Revenue Manual.

### 3.4 GOING CONCERN

In order to discuss to what extent business restructurings may fall within the scope of application of national transfer pricing provisions, it should first be examined *how* business restructurings should be reviewed from a transfer pricing perspective in Russia, Finland and the USA, if a business restructuring involves a transfer of a whole business unit. In general, two different approaches to analyze transfer pricing aspects of business restructurings can be seen in this regard, as mentioned earlier. The first, rather traditional, approach is that each asset and/or something of value transferred in a business restructuring shall be reviewed and valued separately, meaning that related companies must identify all the assets and/or something of value that fall within the scope of national transfer pricing regulations, after which they must remunerate each transfer of an asset and/or something of value separately in accordance with the arm's length principle. The functional analysis discussed in the previous section helps taxpayers to identify the transfers of assets and/or something of value occurring in the course of a business restructuring.

The second — newer and more advanced — approach is to regard a business restructuring as a transfer of a *going concern*, in which case only one arm's length compensation shall be determined — the compensation for the transfer of a business as a going concern.<sup>245</sup> This approach requires that a functioning business unit, a going concern<sup>246</sup>, is transferred in the course of a business restructuring from one related party to another. If the business restructuring involves only transfers of certain assets and/or risks, which do not constitute a functioning business as such, a going concern is not transferred in that case. The aforementioned traditional approach shall be applied to such situations: all the transfers of assets and/or something of value shall be identified and valued separately.

The advantage of regarding business restructurings as transfers of a going concern is that there is no need to examine separately in the aforesaid manner, which of the transferring assets/something of value fall within the scope of national transfer pricing regulations in the business restructuring, and which do not. Instead of determining an arm's length compensation for each asset transfer, which may be burdensome, only one transfer price shall be determined for the transferred business unit. This transfer price, usually based on the future earnings stream of the transferred business, shall cover the

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<sup>245</sup> De Robertis – Matthias – Damian 2006, p. 18.

<sup>246</sup> A going concern has been described as a “functioning organizational unit” and the value of a going concern is therefore higher than the values of separate assets, which belong to this unit, see more in Kroppen – Silva 2011, p. 43. A going concern value as a form of intangible property possibly transferred in a business restructuring is discussed in Section 3.6.5.

transfers of all of the assets and something of value related to the transferred business unit.<sup>247</sup> If possible, tax authorities try to allege that a going concern has been transferred in a business restructuring, as it generally results in that a higher value is subject to (exit) taxation and thus to transfer pricing.<sup>248</sup> On the other hand, treating a business restructuring as a transfer of a going concern in such situations might also lead to a more reliable arm's length result, as independent parties would likely value a functioning business unit on an aggregate basis in similar transactions.<sup>249</sup> Few countries have expressly regulated that business restructurings may be considered transfers of a going concern for transfer pricing purposes.<sup>250</sup>

Thus, in order to discuss the main question of this chapter — to what extent business restructurings become objects of national transfer pricing regulations — it should be examined whether it is possible to regard business restructurings as transfers of a going concern in Russia, Finland and the USA or should transfers of assets and/or something of value occurring in the course of a business restructuring always be reviewed separately. In this section, it is therefore discussed whether business restructurings may be objects of transfer pricing as transfers of a going concern in the target countries.

Before analyzing whether business restructurings may be considered transfers of a going concern pursuant to the national sources of law of Russia, Finland and the USA, it must be highlighted that the OECD has acknowledged the concept of a going concern in its guidelines (the OECD uses the concept of an *ongoing concern* to describe the same phenomenon). The OECD Transfer Pricing Guidelines' starting point is that the arm's length principle should be applied "on a transaction-by-transaction basis." However, if there are many separate transactions, which are conducted together or otherwise closely linked with each other, the main rule could be ignored and such transactions could be reviewed on an aggregate basis.<sup>251</sup> In business restructurings, the OECD has recognized the possibility of the latter and has expressly taken a

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<sup>247</sup> On the other hand, the determination of a transfer price for a going concern is not an easy task either. This will be discussed in more detail in Chapter 4.

<sup>248</sup> Kroppen – Silva 2011, p. 42; Hopkins 2007, pp. 7–8.

<sup>249</sup> See e.g. OECD Transfer Pricing Guidelines, 9.69.

<sup>250</sup> As discussed, Germany has regulated the transfer pricing aspects of business restructurings. German transfer pricing provisions are included in the tax act concerning foreign transactions (*Außensteuergesetz*). See more in Van Herksen – Levey – Fletcher 2008, p. 16. According to the German provisions, in business restructurings, among other things, the company's functions, risks and profit potential related to a business are transferred as a whole, and only one arm's length compensations shall be determined for such a transfer.

<sup>251</sup> OECD Transfer Pricing Guidelines, 3.9.

stand on considering business restructurings as transfers of a going concern. According to the guidelines,

“Business restructurings sometimes involve the transfer of an ongoing concern, i.e. a functioning, economically integrated business unit. The transfer of an ongoing concern in this context means the transfer of assets, bundled with the ability to perform certain functions and bear certain risks. --- The valuation of a transfer of an ongoing concern should reflect all the valuable elements that would be remunerated between independent parties in comparable circumstances. --- For example, in the case of a business restructuring that involves the transfer of a business unit that includes, among other things, research facilities staffed with an experienced research team, the valuation of such ongoing concern should reflect, among other things, the value of the facility and the impact (e.g. time and expense savings) of the assembled workforce on the arm's length price. ---”<sup>252</sup>

Thus, according to the OECD Transfer Pricing Guidelines, if the business restructuring comprises simultaneous transfers of assets, risks or functions, which constitute a functioning and economically integrated business unit, it may be preferable to value the transfers on an aggregate basis, rather than separately. This also means that the arm's length compensation for this kind of transfer of an ongoing concern may not be absolutely equivalent to the aggregate sum of separately valued assets, risks and/or functions transferred in the course of a business restructuring. Pursuant to the OECD Transfer Pricing Guidelines,

“The determination of the arm's length compensation for a transfer of an ongoing concern does not necessarily amount to the sum of the separate valuations of each separate element that comprises the aggregate transfer. In particular, if the transfer of an ongoing concern comprises multiple contemporaneous transfers of interrelated assets, risks, or functions, valuation of those transfers on an aggregate basis may be necessary to achieve the most reliable measure of the arm's length price for the ongoing concern. Valuation techniques that are used, in acquisition deals, between independent parties may prove useful to valuing the transfer of an ongoing concern between associated enterprises. ---”<sup>253</sup>

The OECD Transfer Pricing Guidelines therefore suggest that the arm's length price for a transfer of an ongoing concern could be determined by using

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<sup>252</sup> OECD Transfer Pricing Guidelines, 9.68.

<sup>253</sup> OECD Transfer Pricing Guidelines, 9.69.

valuation methods that are generally used in corporate acquisitions by independent parties. By applying this approach, there would be no need to separately examine which of the transferring assets (and transfers of something of value) would fall within the scope of national transfer pricing regulations in a business restructuring, and which would not, as the arm's length compensation would be paid for the whole functioning business unit. Thus, the compensation would not be based on the sum of the separate valuations of each transferred asset. It should be observed that taxpayers might also be *obliged* to apply this approach, if it is in the aforementioned manner "necessary to achieve the most reliable measure of the arm's length price."

Could business restructurings be considered transfers of a going concern also under Russian law, which would lead to taxpayers avoiding to identify all the transfers of assets and something of value occurring in business restructurings, when a functioning business unit is transferred? Very little support can be found for such a view from the main sources of Russian transfer pricing and tax law. The Tax Code regulates the transaction types in a precise manner, which fall within the scope of the Russian transfer pricing rules, and transfers of business units on an aggregate basis have not been mentioned in the Tax Code at all. According to the Tax Code, only transfers of *commodities, services and work* fall within the scope of transfer pricing regulations.<sup>254</sup>

Alternatively, the Tax Code's transfer pricing provisions do not expressly state that transactions falling within the scope of transfer pricing rules should always be reviewed separately or that multiple contemporaneous transactions could not be reviewed as a whole for transfer pricing purposes. However, if the aggregation of interrelated transactions would be considered acceptable from this perspective, another problem would arise: the Tax Code does not contain specific provisions, which would regulate the possibility to value simultaneous transfers of assets and/or functions on an aggregate basis. Thus, it would be unclear, for instance, how the arm's length compensation would be determined in such situations.

Moreover, it must be observed that, as discussed earlier, the interpretation of Russian law and overall judicial discretion under Russian law are basically based only on written legal norms.<sup>255</sup> From this perspective, it may be extremely difficult to find justification for a view according to which assets and functions transferred in the course of a business restructuring would not be identified and valued separately, but on an aggregate basis, if no support is evident for such a view in the Tax Code. In the current situation, the transfer

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<sup>254</sup> Article 105.14 of the Tax Code.

<sup>255</sup> Orlov 2010, p. 17.

pricing of contemporaneous transfers of assets and/or something of value as a going concern has not been dealt with in the Russian case law nor other sources of Russian tax law, including the Minfin's or the FTS's clarifications and other administrative guidance. Hence, other acceptable sources of Russian tax law that can be used in the interpretation of the Tax Code's provisions also remain silent in this respect. Therefore, at least strictly from the perspective of the current Russian national transfer pricing provisions and regulations, it is likely that business restructurings should always be examined in a traditional way. This would mean that all the transfers of assets and something of value occurring in a business restructuring should be identified and valued separately in accordance with the Tax Code's transfer pricing rules, regardless of whether such assets and something of value would constitute a functioning business unit as a whole.

On the other hand, as Russian law does not itself provide a straightforward answer to the question, whether business restructurings could be regarded as transfers of a going concern for transfer pricing purposes, could the OECD's approach be applied to business restructurings purely on the basis of the OECD Transfer Pricing Guidelines? As mentioned earlier, Russia is not a member of the OECD and the OECD Transfer Pricing Guidelines are not legally binding even on its member states. Nevertheless, the representatives of the Russian tax authorities have publicly stated that the OECD Transfer Pricing Guidelines can be used at least as *interpretive help*, when Chapter V.1 of the Tax Code is applied in practice. This is due to the fact that Chapter V.1's transfer pricing provisions were largely based on the OECD Transfer Pricing Guidelines and correspond to them to a great degree.<sup>256</sup> It was also previously discussed that the OECD Transfer Pricing Guidelines cannot be entirely ignored in Russia and should be used as interpretive help, at least in situations where the applicable Tax Code's transfer pricing provisions are in line with the OECD Transfer Pricing Guidelines' corresponding provisions.

Although the transfer pricing rules regulated in the Tax Code are quite widely consistent with the OECD's transfer pricing rules, they also have their own peculiarities. The most important difference between the Tax Code and the OECD Transfer Pricing Guidelines is that the arm's length principle regulated in the Tax Code is not applicable to controlled transactions, where *intangible assets* are transferred between related parties, while the OECD Transfer Pricing Guidelines have regulated very broadly and in detail the applicability of the arm's length principle to transfers of intangibles in Chapter VI of the OECD Transfer Pricing Guidelines. In addition, while the Minfin has published written clarifications in relation to the scope of application of the Tax Code's transfer pricing regulations, according to which transfers of

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<sup>256</sup> Garant 2011.



intellectual property rights may be subject to transfer pricing regulations, support cannot be found for a view that other intangible assets could fall within the scope of application of Russian transfer pricing rules.<sup>257</sup>

Therefore, as particular Tax Code's provisions regulating the actual scope of application of transfer pricing rules are not in line with the OECD Transfer Pricing Guidelines, it is highly unlikely that the provisions could be interpreted in a way, which would allow business restructurings — which often involve transfers of various intangibles — to be regarded as transfers of a going concern resulting in that the restructuring would be valued on an aggregate basis. Otherwise, the Tax Code would be interpreted contrary to the actual wording of the provision, and the OECD Transfer Pricing Guidelines would not be used only as interpretive help, but as a tool to amend existing legal norms of the Tax Code: the wording, content and scope of the transfer pricing provisions would actually be broadened.

Article 268.1 of the Tax Code regulates the taxation of a transfer of an enterprise.<sup>258</sup> An enterprise is defined as a complex of assets used to practice business activities, which includes e.g. tangible and intangible assets as well as liabilities and risks related thereto.<sup>259</sup> In this sense, the said concept of enterprise resembles the concept of a going concern, although the latter does not necessarily have to be a whole enterprise, but it may also be a separately functioning business unit. The article has been applied in practice only in very rare cases because of its very strict formalities and registration requirements set by the authorities.<sup>260</sup> Besides, the article requires that an enterprise must be transferred with all of its assets and functions to another company. This is not the case in the majority of business restructurings, as group companies are more likely willing to transfer only some of their business activities/units to another group company. More importantly, the article does not have any mention about its applicability to *transfer pricing issues*. It is not even placed in Chapter V.1 of the Tax Code, which primarily includes the Russian transfer

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<sup>257</sup> See Raz"yasneniya Ministerstva Finansov Rossijskoj Federatsii po voprosam primeneniya razdela V.I Nalogovogo kodeksa Rossijskoj Federatsii. The applicability of the Russian transfer pricing regulations to transfers of intangibles will be discussed in more detail in Section 3.6.

<sup>258</sup> Pursuant to the article, when an enterprise is transferred, the difference between the actual purchase price and the net asset value of the enterprise will be regarded as taxable profit or deductible loss of the buyer. It must be noted that the transfer of an enterprise under this article may not include transfers of licenses (authorizations) and other statutory permits nevertheless. See Dontsov – Anichkin – Syrbe 2009, pp. 13–14. See also Article 158 of the Tax Code, which regulates the tax base of transferred enterprises.

<sup>259</sup> Article 132 of the Russian Civil Code.

<sup>260</sup> Kalinov – Drobilko 2010, p. 437; Evdokimov – Konnov 2011, p. 633; Dontsov – Anichkin – Syrbe 2009, p. 14 .

pricing rules in force. Thus, apart from that it may be poorly applied to business restructurings in general, it is very unlikely that the article could be applied to transfer pricing issues at all.

Taking into consideration the above states observations, it is hard to find grounds for the view that business restructurings could be regarded as transfers of a going concern in Russia from the transfer pricing perspective, even when a restructuring would involve a transfer of a functioning business unit. Consequently, the question of whether and to what extent business restructurings may fall within the scope of the transfer pricing regulations in Russia must be thus approached by analyzing different types of transfers of assets and something of value on a transaction-by-transaction basis, which may generally occur in the course of business restructurings. Russian transfer pricing experts have assumed this kind of approach in practice too.<sup>261</sup> In principle, this means that in order to consider certain assets as objects of transfer pricing in business restructuring in Russia, they must be distinguishable from other transferred assets in the restructuring (i.e. identifiable), they have to have value that would be compensated in transactions between independent parties under similar conditions and they should be regulated under Russian tax law as asset types subject to transfer pricing.

The aforementioned approach is nevertheless problematic. The arm's length principle requires ultimately that transactions between related parties conform in terms of commercial conditions to transactions conducted between unrelated parties in comparable circumstances. Thus, if independent parties would treat several simultaneous transfers of assets and other valuable items as a transfer of a functioning business unit, where such transfers would be reviewed and remunerated as a whole,<sup>262</sup> this should be the starting point also in business restructurings. The existing transfer pricing rules and the interpretation thereof do not allow such a conclusion in the aforesaid manner. In the worst-case scenario, this leads to a situation where the sum of separate compensations paid in the restructuring for controlled transfers of assets/something of value may deviate remarkably from the aggregate valuation of such assets/something of value. In such cases, the compensation paid in the restructuring would thus differ considerably from what should be considered the arm's length result in such situations (i.e. what independent

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<sup>261</sup> Expert Interview 2012. According to the interviewees, they have not seen in practice that separate assets associated with a certain business would have been transferred as a whole in a related party transaction. This is not also recommended as it may be in the interest of tax authorities to intervene in such transactions afterwards.

<sup>262</sup> See e.g. OECD Transfer Pricing Guidelines, 9.69. This is usually the case in business acquisitions also in Russia; see e.g. Popkov – Evstafeva 2007, pp. 84–85.

parties would regard as appropriate compensation). In this sense, the purpose of the arm's length principle, which should be the guiding principle behind the national transfer pricing provisions also in Russia, is not necessarily completely realized in this particular transfer pricing question. Hence, the existing transfer pricing rules should be amended *de lege ferenda* to better meet the aims of the arm's length principle in this respect.

In the Finnish tax legislation, there are no specific provisions regulating the transfer pricing aspects of business restructurings. The general transfer pricing rules are thus the starting point, when the transfer pricing of business restructurings is reviewed. § 31 of the AAP does not restrict the scope of application of the transfer pricing rules only to particular types of transactions conducted between related parties in comparison with the corresponding Russian rules; no special conditions on the nature of the controlled transactions are imposed, as discussed earlier. This results in that the general requirement of complying with the arm's length principle primarily applies also to business restructurings.<sup>263</sup>

As § 31 of the AAP provides insufficient information in relation to applying the arm's length principle in practice, the question of whether business restructurings may be regarded as transfers of a going concern for transfer pricing purposes must be examined from other sources of Finnish tax law. According to the preliminary works of the AAP, § 31 of the AAP must be interpreted broadly; it states that controlled transactions falling within the scope of transfer pricing provisions may be, for example, ordinary sale and purchase activities as well as transfers of intangible assets.<sup>264</sup> Pursuant to the preliminary works of the AAP, the transfer pricing provisions of the AAP are widely based on the OECD Transfer Pricing Guidelines, and the preliminary works contain several references to the OECD Transfer Pricing Guidelines.<sup>265</sup> As the scope of application of the Finnish transfer pricing provisions is in line with the OECD Transfer Pricing Guidelines and they are also to a large extent based on the said guidelines, it could mean that the OECD Transfer Pricing Guidelines' approach to business restructurings, including the possibility of regarding business restructurings as transfers of a going concern, could also be applied to business restructurings in Finland.

As stated earlier, in addition to the preliminary works, the guidance provided by the Finnish Tax Administration plays a pivotal role in the Finnish transfer pricing. According to the Finnish Tax Administration's memorandum, § 31 of the AAP must be interpreted in accordance with the principles of the OECD

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<sup>263</sup> Jaakkola et al. 2012, p. 251.

<sup>264</sup> HE 107/2006 vp, p. 20.

<sup>265</sup> HE 107/2006 vp, pp. 3, 10–11, 14–18.

Transfer Pricing Guidelines.<sup>266</sup> The memorandum also deals with business restructurings in particular. Pursuant to the memorandum, a functional analysis should contain information about business restructurings and other changes in the business models of a company, if applicable. Such changes may involve transfers of functions as well as transfers of assets and risks related to such functions. It is especially noteworthy to observe that, according to the memorandum, changes (e.g. business restructurings) must be reviewed as a whole.<sup>267</sup> In the legal literature, it has been viewed that the concept and meaning of business restructuring under the memorandum may be deemed to be equivalent to the concept and meaning of business restructuring regulated in Chapter IX of the OECD Transfer Pricing Guidelines.<sup>268</sup> More recently, the Finnish Tax Administration has also publicly stated on its website as a guidance for taxpayers that business restructurings must be treated as transfers of a going concern, when a functioning business is transferred in the restructuring.<sup>269</sup> From this point of view, it is thus self-evident that the Finnish Tax Administration views that business restructurings may — and should — be regarded as transfers of a going concern in Finland, in accordance with the OECD Transfer Pricing Guidelines, when a functioning and economically integrated business unit is transferred in a business restructuring.

The OECD Transfer Pricing Guidelines' relevance in Finland cannot be overemphasized in business restructuring cases. The Supreme Administrative Court has specifically stated that, when Chapter IX of the OECD Transfer Pricing Guidelines was introduced in 2010, it did not bring any material amendments to the practice with regard to the interpretation of the arm's length principle, but rather brought clarification to the application of the arm's length principle in new kinds of environments.<sup>270</sup> More importantly, it ruled that the principles and regulations of the OECD Transfer Pricing Guidelines can be used in their present form (including Chapter IX) as a guide for the application of the arm's length principle in Finland.<sup>271</sup> Despite the fact that, in the case, the Supreme Administrative Court did not specifically address the possibility of regarding business restructurings as transfers of a going concern, this statement in conjunction with the express references to Chapter IX of the OECD Transfer Pricing Guidelines supports the view that business restructurings could be considered transfers of a going concern in situations

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<sup>266</sup> Finnish Tax Administration Memorandum 1471/37/2007, p. 4.

<sup>267</sup> Finnish Tax Administration Memorandum 1471/37/2007, pp. 25–26.

<sup>268</sup> Jaakkola et al. 2012, p. 251.

<sup>269</sup> Finnish Tax Administration: Transfer Pricing in Business Restructurings.

<sup>270</sup> See KHO 2013:36. For instance, the application of the arm's length compensation to situations involving location savings.

<sup>271</sup> Ibid.

where a functional business unit is transferred in the sense set out in the provisions of the OECD Transfer Pricing Guidelines.

It should also be observed that the preliminary rulings practice of the Finnish Large Taxpayers' Office supports the aforementioned view. In its preliminary rulings, the Finnish Large Taxpayers' Office has taken as a starting point that business restructurings may be regarded as transfers of a going concern for transfer pricing purposes, when a functional business unit is transferred from one related party to another. In such cases, the arm's length compensation shall be determined solely for the transferred unit, and there is no need to separately value, for instance, intangibles that belong to such a unit. This approach is thus similar to acquisition deals conducted between independent parties, which concern transfers of businesses.<sup>272</sup> As mentioned earlier, despite the fact that the Finnish Large Taxpayers' Office is not a court, its rulings provide useful interpretations of legal provisions, which should always be taken into consideration.

Given that the Finnish legal literature has also viewed that business restructurings may be examined as transfers of a going concern for transfer pricing purposes,<sup>273</sup> it is justified to state that Finnish law follows the OECD Transfer Pricing Guidelines' approach to business restructurings in this regard and deviates from the approach of Russian law. When a business restructuring involves a transfer of a functioning, economically integrated business unit (i.e. going concern), it may be required that contemporaneous transfers of assets, risks, and/or functions executed between related parties in the course of such a business restructuring shall be reviewed and valued in Finland on an aggregate basis, not separately. This results in that the determination of the arm's length compensation in such cases could be made by using the valuation techniques that are commonly used in business acquisition deals between independent parties,<sup>274</sup> and the determinations of separate arm's length compensations for each asset transfers occurring in the business restructuring would not be necessary.

In comparison with the prevailing legal situation in Russia, similar interpretive problems are avoided in Finland. Although the written provisions are strongly binding law, also other sources of law — such as court decisions, preliminary works and jurisprudence — are permitted sources of law in Finland. Therefore, all such sources may be used in the interpretation of the legislated transfer pricing rules in the above-mentioned sense more extensively than in Russia. Moreover, more weight has been given in general

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<sup>272</sup> Laaksonen 2006, p. 435.

<sup>273</sup> Juusela – Tuominen 2011, pp. 317–319.

<sup>274</sup> See OECD Transfer Pricing Guidelines, 9.68–9.69.

to other sources than the actual transfer pricing provision (§ 31 of the AAP), when the actual content of the arm's length principle pursuant to Finnish law is discussed and interpreted. The treatment of business restructurings as transfers of a going concern has been recognized by the said sources in a similar manner as in the OECD Transfer Pricing Guidelines. Furthermore, the interpretation of the Finnish transfer pricing provisions is heavily based on the OECD Transfer Pricing Guidelines in such sources, and the position of the OECD's guidance as a guiding source in the Finnish transfer pricing has been confirmed by the Supreme Administrative Court and the Finnish Tax Administration. Therefore, there is no similar lack of clarity in the existing situation as in Russia with respect to the possibility of considering contemporaneous transfers of assets/something of value as transfers of a going concern for transfer pricing purposes.

In consequence, the requirements of the arm's length principle are also met in this particular question: if independent parties would consider in comparable circumstances contemporaneous transfers of assets/something of value as a transfer of a going concern and determine a single transfer pricing for such transfers on an aggregate basis, such an approach should also be applied by related parties pursuant to the Finnish legal sources. Due to the different hierarchy of laws and judicial systems, no similar amendments to the existing provisions are required *de lege ferenda* in Finland as compared to Russia.

Naturally, when a business restructuring involves only transfers of specific assets/something of value, which do not constitute a functioning business unit, Finnish and Russian law are in line with each other. In such situations, all transfers of assets and/or something of value occurring in the course of a business restructuring must be identified and valued separately, if they fall within the scope of application of national transfer pricing provisions.

In U.S. transfer pricing, the possibility to consider business restructurings as transfers of a going concern for transfer pricing purposes must be examined from the main sources of law regulating transfer pricing — Section 482 of the IRC and the Treasury Regulations related thereto.<sup>275</sup> Section 482 does not regulate business restructurings or transfers of going concerns/business units as such and is thus not very helpful in this respect. For instance, it lacks any rules according to which specific exit taxes are imposed on outbound transfers of functions in the course of business restructurings.<sup>276</sup> On the other hand,

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<sup>275</sup> A going concern or business is in general defined in U.S. tax law as “a specific unified group of activities that constitute (or could constitute) an independent economic enterprise carried on for profit,” see Treas. Reg. § 1.367(a)–2T(b)(2). Thus, the concept is understood in a similar way as in Russian and Finnish law.

<sup>276</sup> MacGregor 2014, p. 2.

Section 482 does not explicitly restrict the scope of application of the transfer pricing rules only to particular types of transactions conducted between related parties, and in this regard it resembles more the Finnish transfer pricing provisions than the Tax Code's rules. The Treasury Regulations, which interpret Section 482, are therefore valuable in examining the question of whether business restructurings may be treated as transfers of a going concern for transfer pricing purposes under U.S. law.

The so-called *best method rule* defined under § 1.482-1(c) of the Treasury Regulations regulates the application of transfer pricing methods to controlled transactions in order to obtain the best and most reliable result from the perspective of the arm's length principle. Pursuant to the regulation, "the arm's length result of a controlled transaction must be determined under the method that, under the facts and circumstances, provides the most reliable measure of an arm's length result. Thus, there is no strict priority of methods, and no method will invariably be considered to be more reliable than others." The best method rule is naturally also the starting point, when considering whether a business restructuring may be regarded as a transfer of a going concern for transfer pricing purposes. The best method rule could be basically interpreted in the business restructuring context that it may be possible to regard business restructurings as transfers of a going concern, if it would result in the most reliable end result in terms of the arm's length principle.

This view can be supported by the fact that the Treasury Regulations also contain particular regulations according to which the best method rule may require that separate, but contemporaneous, transactions are analyzed on an aggregate basis. On 14 September 2015, the IRS and the U.S. Treasury Department published temporary regulations, which amended the former final regulations dealing with the question of the aggregated arm's length analysis of interrelated controlled transactions. According to the regulations,

"The combined effect of two or more separate transactions (whether before, during, or after the year under review), including for purposes of an analysis under multiple provisions of the Code [= the IRC] or regulations, may be considered if the transactions, taken as a whole, are so interrelated that an aggregate analysis of the transactions provides the most reliable measure of an arm's length result determined under the best method rule of § 1.482-1(c). Whether two or more transactions are evaluated separately or in the aggregate depends on the extent to which the transactions are economically interrelated and on the relative reliability of the measure of an arm's length result provided by an aggregate analysis of the transactions as compared to a separate analysis of each transaction. For example, consideration of the combined effect of two or more transactions may be appropriate to determine whether the overall compensation in the transactions is

consistent with the value provided, including any synergies among items and services provided.”<sup>277</sup>

In addition, the temporary regulations contain provisions on the so-called *coordinated best method analysis*: “A coordinated best method analysis and evaluation of *two or more controlled transactions* to which one or more provisions of the Code [= the IRC] or regulations apply may be necessary to ensure that the overall value provided, including any synergies, is properly taken into account.” The coordinated best method analysis requires a consistent consideration of the facts of the functions performed, resources used and risks assumed in the controlled transactions as well as a consistent measure of the arm's length results.<sup>278</sup>

These Treasury Regulations provide a solid support for the aforementioned view that business restructurings could be treated as transfers of a going concern under U.S. law, at least in some cases, as it allows the IRS and taxpayers to analyze two or more interrelated transactions as a whole for transfer pricing purposes. As previously dealt with, the administrative sources — especially the Treasury Regulations — interpret the IRC's narrow regulations, and they must be followed in practice by the IRS and taxpayers. The Treasury Regulations refer to transactions, which are *economically interrelated*. When a business restructuring involves a transfer of a going concern, it usually means that several contemporaneous transactions, wherein assets/something of value, risks and/or functions are transferred within a group, occur. As these assets/something of value, risks and/or functions should constitute an integrated and functioning business unit in order to be regarded as a going concern, such transactions can be considered economically interrelated in the above-mentioned sense.

In addition to the requirement of being to a sufficient extent economically interrelated, the evaluation of the transactions on an aggregate basis in a business restructuring pursuant to the aforesaid regulations would require that the arm's length results in that case could be measured in a relatively reliable way as compared to a separate analysis of each transaction in the restructuring. In this respect, the combined effect of two or more transactions, such as synergies, must be taken into account. A going concern is a complex of assets/something of value forming a functioning and integrated business unit, which is able to carry out business activities (and assume liabilities related thereto) independently, as discussed earlier. Assets and something of value belonging to such a unit together constitute additional values, like synergies,

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<sup>277</sup> Treas. Reg. § 1.482-1T(f)(2)(i)(B).

<sup>278</sup> Treas. Reg. § 1.482-1T(f)(2)(i)(C).



in addition to their separate valuations.<sup>279</sup> If a transfer of a going concern would be analyzed and valued on an asset-by-asset/transaction-by-transaction basis, there might be a risk that such additional values would not be reflected in the separate valuations of assets/something of value sufficiently. The combined effect of two or more controlled transactions would thus not be taken into consideration as required by the aforementioned provisions of the Treasury Regulations. The most reliable measure in terms of the arm's length result would therefore be achieved more likely by analyzing and valuing the interrelated transactions, wherein the assets/something of value belonging to a going concern are transferred, on an aggregate basis.

The Treasury Regulations thus clearly indicate the possibility of analyzing several simultaneous transactions occurred in the course of business restructurings as a whole under circumstances similar to the OECD's guidance. In practice, this means that if a business restructuring involves several contemporaneous transfers of assets and something of value, it should be examined whether the transfers are economically so interrelated that an aggregate analysis of the transactions provides the most reliable measure of the arm's length result in accordance with the best method rule.<sup>280</sup> Transfers of a going concern are very likely to meet the requirements of the regulations in the above-discussed manner, although the wordings of the provisions do not expressly require that the assets/something of value transferred simultaneously should together constitute a functioning business unit.

It must also be observed that the aggregation of interrelated transactions has not been questioned in the U.S. case law nor legal literature. Courts have recognized in their rulings the possibility of analyzing interrelated transactions on an aggregate basis.<sup>281</sup> In addition, in the legal literature, it has

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<sup>279</sup> See e.g. OECD Transfer Pricing Guidelines, 9.68–9.69.

<sup>280</sup> It must be noted that the above-discussed Treasury Regulations are temporary in nature, which means that a lack of clarity exists in relation to whether they are factually legally binding; see e.g. Lederman – Mazza 2011, pp. 1–2. However, in practice, temporary regulations are followed by tax authorities and in general also by taxpayers as of their publication (as it was discussed earlier, temporary regulations become effective immediately as of the date of their issuance; in this case, as of 14 September 2015) and thus have in principle legal effect. In addition, the former final regulations, which were amended by the newest temporary regulations, recognized the same possibility of analyzing interrelated controlled transactions on an aggregate basis, if that would lead to the most reliable result from the perspective of the arm's length principle as required by the best method rule; see former Treas. Reg. § 1.482-1(f)(2)(i)(A).

<sup>281</sup> Despite not questioning the possibility of the aggregation of transactions in general, courts have more often decided that the aggregation has not been possible in the specific case; see e.g. Kraft Foods Co. v. Commissioner, 21 T.C. 513 (1954), Bausch & Lomb Inc. v. Commissioner, 933 F.2d 1084 (2d Cir. 1991), Claymont Investments, Inc. v. Commissioner, T.C. Memo 2005-254 (2005) and Veritas Software

been viewed that the aggregation of several related party transactions may be possible, especially when there can be found a business relation between such transactions. In particular, when the case concerns several separate transactions involving transfers of intangibles, the business perspective, i.e. whether intangible assets are interrelated through a business connection, becomes important.<sup>282</sup> The most noteworthy issue to observe is that the possibility of regarding particularly business restructurings as transfers of a going concern for transfer pricing purposes has been considered possible also in the U.S. legal literature.<sup>283</sup>

Taking into account the aforementioned observations, business restructurings can — and should — be very likely regarded as transfers of a going concern for transfer pricing purposes in the USA in the event that the requirements set out in the Treasury Regulations are met. Thus, U.S. and Finnish law — as well as the OECD Transfer Pricing Guidelines — have taken largely similar approaches in this respect. Although the Treasury Regulations lacked specific provisions in terms of evaluating transactions as a whole especially in the business restructuring context, the application of the general regulations regarding the aggregation of transactions conform to the above-discussed provisions of the OECD Transfer Pricing Guidelines. Pursuant to the OECD Transfer Pricing Guidelines — which are followed to a great degree in Finland in this question — when a business restructuring involves a transfer of a functioning business unit, several contemporaneous transfers of interrelated assets, risks and functions may be examined and valued as a whole, when it is “necessary to achieve the most reliable measure of the arm’s length price for the ongoing concern.” Correspondingly, in the USA, the economically interrelated transactions may be evaluated on an aggregate basis, when the aggregation of transactions provides “the most reliable measure of an arm’s length result” in accordance with the best method rule.<sup>284</sup>

Consequently, as was the case in Finland, the existing situation in the USA effectively requires compliance with the arm’s length standard also in business restructurings, which involve transfers of a functioning business unit (going concern). If a business restructuring involves several contemporaneous and

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Corporation v. Commissioner, 133 T.C. 297 (2009). See also *Guidant LLC v. Commissioner*, 146 T.C. No. 5 (2016), where the Tax Court confirmed the IRS’s right to analyze contemporaneous transactions on an aggregate basis pursuant to the Treasury Regulations.

<sup>282</sup> Wittendorff 2010a, p. 344. It has also been stated that the aggregation of interrelated transactions may be topical in situations where transactions involve products falling within a marketed portfolio of products or the products have been divided into separate product lines; see Levey – Wrappe – Chung 2006, p. 19.

<sup>283</sup> Zollo 2011, pp. 769–770.

<sup>284</sup> OECD Transfer Pricing Guidelines, 9.68–9.69; Treas. Reg. § 1.482-1T(f)(2)(i)(B).

interrelated transactions under which tangible and intangible assets, risks and functions are transferred between related parties, it must be considered whether business restructurings should be regarded as transfers of a going concern for transfer pricing purposes to achieve the best arm's length result. This means that transactions occurred therein should be valued on an aggregate basis, if the aggregation of such transactions would lead to the best result from the perspective of the arm's length. In this respect, no similar amendments to the existing provisions are required as compared to the Russian Tax Code.

The difference between U.S. and Russian law for this question can be explained in a similar manner as for Finland with reference to the different hierarchy of laws and judicial systems. The administrative sources — especially the Treasury Regulations — provide interpretations of the IRC's narrow transfer pricing provision, and they must be followed in practice by the IRS and taxpayers in order to achieve the best arm's length result. As the Treasury Regulations require the aggregation of interrelated transactions in the aforesaid manner under certain circumstances, business restructurings should be correspondingly regarded as transfers of a going concern in such circumstances in order to meet the requirements of the arm's length standard.

In conclusion, the approach taken by Finnish and U.S. law cannot be applied in Russia, as no legal support can be found for such a view. Business restructurings must always be examined in Russia on a transaction-by-transaction basis, when it comes to transfer pricing. All the assets and/or something of value transferred in the course of a business restructuring need to be analyzed and valued separately. This means that group companies must identify all transfers of assets and/or something of value that fall within the scope of application of the Tax Code's transfer pricing provisions, after which they must determine an arm's length compensation for each such transfer. As discussed, the general requirements of the arm's length principle, which should be the guiding principle behind the Tax Code's transfer pricing provisions, are not necessarily met in this transfer pricing question if unrelated parties would in comparable situations review several interrelated transactions on an aggregate basis. Hence, in contrast to the Finnish and U.S. transfer pricing rules, the existing Russian transfer pricing rules should be amended *de lege ferenda* to better meet the aims of the arm's length principle in this respect.

Conversely, it must be noted that if a business restructuring involves only transfers of certain assets, which do not constitute a functioning business unit, a going concern is not transferred in the business restructuring. In that case, transfers of assets, such as transfers of tangible and intangible assets, must primarily be valued on a transaction-by-transaction basis also in Finland and

the USA. Thus, the laws of the target countries conform to each other in such situations.

Next, it will be discussed on an asset-by-asset basis, what kinds of assets and something of value may fall within the scope of transfer pricing regulations in Russia, Finland and the USA separately, when business restructurings do not involve a transfer of a functioning business unit, i.e. going concern. In particular, it will be explored to what extent certain types of assets may become objects of transfer pricing. Tangible assets will be dealt with first briefly, after which transfers of intangible assets will be discussed more extensively as being a question of great importance in transfer pricing at present. Lastly, it will be examined whether transfers of risks or premature terminations/renegotiations of agreements may be subject to transfer pricing alone in business restructurings.

### **3.5 TANGIBLE ASSETS**

The question of whether tangible assets may become objects of transfer pricing in business restructurings is generally quite unproblematic. A business restructuring may involve a transfer of tangible assets from a group company to a foreign related company. For instance, business restructurings may result in changes in a multinational enterprise's manufacturing activities. A group company may operate as a fully-fledged manufacturer before a business restructuring. As previously discussed, this means that the company acquires raw materials, manufactures products, takes care of its marketing activities and sells the finished products to third parties. When the group company, as a result of the business restructuring, starts operating as a toll-manufacturer, it focuses only on the manufacturing of products, and a related company, which e.g. has been established in connection with the restructuring, now owns raw materials and takes care of the marketing and sales activities. In this business restructuring example, raw materials and intangible assets used in marketing and sales activities are transferred in a related party transaction from one group company to another.<sup>285</sup> In addition to raw materials, other tangible assets, which may be transferred in the course of a business restructuring between related parties, are finished products and production machinery used in the manufacturing of goods from raw materials. The question with regard to transfers of tangible assets in business restructurings has not been regarded as a particularly difficult question from the transfer pricing perspective.<sup>286</sup>

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<sup>285</sup> OECD Transfer Pricing Guidelines, 9.49–9.51. See also e.g. Russo 2007, pp. 184–186.

<sup>286</sup> See e.g. former paragraph 9.75 of the OECD Transfer Pricing Guidelines. On the other hand, the determination of the arm's length compensation for inventories transferred in a business restructuring may be troublesome, see OECD Transfer Pricing Guidelines, 9.49–9.54.

As business restructuring may involve transfers of tangible assets, the next question is, whether they may become objects of transfer pricing as separate items pursuant to the Russian, Finnish and U.S. transfer pricing provisions. This means that, in order to consider tangible assets as being subject to transfer pricing in a business restructuring separately, they must be distinguishable from other transferred assets in the restructuring (i.e. identifiable from other possible transfers of something of value occurring in a business restructuring). Naturally, they must also have value, which would usually be compensated in similar transactions conducted between independent parties under similar conditions. Finally, tangible assets should also be regulated under national tax laws as asset types subject to transfer pricing and the arm's length principle.

Tangible assets, such as raw materials, used in business activities are usually easy to distinguish from other possible assets and/or something of value transferred in a business restructuring. For example, transfers of machinery can be generally separated from transfers of intangibles. In addition, tangible assets clearly have value, which would be compensated in similar transactions between independent parties, as normally independent parties would remunerate transfers of raw materials or finished products. Thus, the question of whether tangible assets may become objects of transfer pricing separately in business restructurings must be ultimately examined from the national transfer pricing provisions.

In Russia, the Tax Code specifically mentions transfers of commodities<sup>287</sup> as objects of transfer pricing.<sup>288</sup> Thus, there is no ambiguity in whether transfers of tangible assets fall within the scope of application of Russian transfer pricing regulations, if a business restructuring involves transfers of them. The arm's length principle is hence followed in this regard, and no such interpretive problems arise as from transfers of a going concern.

On the contrary, the legislated Finnish transfer pricing provisions do not mention whether tangible assets fall within the scope of application of the transfer pricing rules. However, they also do not restrict the scope of application of the transfer pricing rules to specific types of transactions conducted between related parties, and thus no special conditions on the nature of controlled transactions has been regulated.<sup>289</sup> As discussed earlier,

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<sup>287</sup> Russian term used in the legislation, *tovary*, can also be understood as goods or products. In general, it means a physical property. The Tax Code refers to it as any kind of property, which is sold/transferred or to be sold/transferred, see Article 38 of the Tax Code.

<sup>288</sup> Article 105.14 of the Tax Code.

<sup>289</sup> § 31 of the AAP.

the transfer pricing regulations of the AAP are widely based on the OECD Transfer Pricing Guidelines, and the preliminary works contain several references to the OECD Transfer Pricing Guidelines.<sup>290</sup> In addition to the preliminary works, the Finnish Tax Administration and the Supreme Administrative Court of Finland have stated that § 31 of the AAP must be interpreted in accordance with the principles of the OECD Transfer Pricing Guidelines.<sup>291</sup> Pursuant to the OECD Transfer Pricing Guidelines, transfers of tangible assets are subject to transfer pricing, when such transfers occur in business restructurings.<sup>292</sup> Furthermore, the preliminary works of the AAP have expressly stated that related party transactions may generally concern, among other things, the sale and purchase of goods between controlled parties.<sup>293</sup> Moreover, in the Finnish legal literature it has been considered self-evident that transfers of tangible assets are subject to transfer pricing.<sup>294</sup> It is thus justified to state that tangible assets fall within the scope of application of the Finnish transfer pricing rules, if they are transferred between related parties in a business restructuring.

Similarly, the legislated U.S. transfer pricing provision, Section 482 of the IRC, does not directly regulate transfers of tangible assets. As was the case in Finland, Section 482 does not limit the application of transfer pricing rules only to certain types of controlled transactions.<sup>295</sup> The Treasury Regulations provide more information in terms of transfer pricing of tangible assets. The regulations comprise provisions on the transfer pricing methods applicable to transfers of tangible property in controlled transactions.<sup>296</sup> As the Treasury Regulations have these kinds of particular provisions targeted at transfer pricing of tangible assets, this is a clear indication that transfers of tangible assets fall generally within the scope of the U.S. transfer pricing provisions. This has been considered unproblematic in the legal literature<sup>297</sup> as well as in

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<sup>290</sup> HE 107/2006 vp, pp. 3, 10–11, 14–18.

<sup>291</sup> See Finnish Tax Administration Memorandum 1471/37/2007, p. 4; KHO 2013:36.

<sup>292</sup> OECD Transfer Pricing Guidelines, 9.49–9.54.

<sup>293</sup> HE 107/2006 vp, pp. 15 and 20.

<sup>294</sup> Jaakkola et al. 2012, p. 141.

<sup>295</sup> Although it specifically mentions transfers of intangible assets as transaction types falling in the scope of application. This will be discussed in more detail in the following section.

<sup>296</sup> See Treas. Reg. § 1.482-3, which deal with methods in relation to determining taxable income in connection with a transfer of tangible property and which is specifically applied to controlled transfers of tangible property.

<sup>297</sup> See e.g. King 2004, p. 3; Madrian – Weise 2014, pp. 765–766.

case law<sup>298</sup>, which is why the transfer pricing rules should be generally applied to controlled transfers of tangible assets.<sup>299</sup>

However, the IRC also contains specific provisions on the so-called non-recognition rules for outbound transactions, under which particular assets may be transferred free of tax from a U.S. company to a foreign company under certain exceptional circumstances. If transfers of specific assets could qualify for such a non-tax treatment, they may correspondingly not be subject to transfer pricing either. Under a general rule, *domestic* transfers of assets may be tax-free, if such transfers are conducted in connection with an exchange for stock or securities of a company in situations where the company is incorporated, liquidated or reorganized.<sup>300</sup> This non-recognition rule is not primarily applicable to *cross-border, outbound transactions*: if a U.S. company transfers assets to a foreign company in connection with such exchanges, a gain must be recognized in such assets.<sup>301</sup> Nonetheless, there is also an exception, which allows the application of the non-recognition rule to outbound transfers of assets: if certain assets are transferred from a U.S. company to a foreign corporation “for use by such foreign corporation in the active conduct of a trade or business outside of the United States,” such outbound transfers of assets may qualify for the tax-free treatment similar to domestic transactions. Pursuant to the Treasury Regulations, this exception may be applied, *inter alia*, to transfers of tangible property.<sup>302</sup>

Nevertheless, not all the tangible assets are eligible for this exception. For instance, inventories as well as depreciated tangible properties, which have been used in the USA, are not entitled to the tax-free treatment.<sup>303</sup> As business restructurings usually involve cross-border transfers of inventories, as well as depreciable machinery and other tangible property, it is unlikely that these provisions could be applied widely to cross-border business restructurings. In addition, the discussed exceptions are applicable only to transactions involving exchanges in the event of reorganization, liquidation or incorporation, and therefore they can be poorly applied to actual *business restructurings*. Besides, as discussed earlier, the concept of business

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<sup>298</sup> See e.g. *Compaq Computer Corp. v. Commissioner*, 277 F.3d 778 (5th Cir. 2001).

<sup>299</sup> Transfers of tangible assets from the transfer pricing perspective have not been discussed in the legal literature that broadly, apart from the methods with regard to determining the arm's length compensation for such transfers in accordance with the aforementioned Treasury Regulations, which will be dealt with in Chapter 4 of this study.

<sup>300</sup> See e.g. Section 351 and 361 of the IRC. Reorganizations may mean, for instance, mergers; see Section 368 of the IRC.

<sup>301</sup> Section 367(a)(1).

<sup>302</sup> Section 367(a)(3) of the IRC; Treas. Reg. § 1.367(a)-2(a)-(b).

<sup>303</sup> Treas. Reg. § 1.367(a)-2(c). See also Sections 4.61.11.1–4.61.11.3 of the Internal Revenue Manual.

restructuring in this research is separated from the so-called reorganizations, such as mergers, divisions and exchanges of shares. Hence, such non-recognition rules may not be ultimately applied to transfers of tangible property in business restructurings in this study's scope, and interpretive problems are respectively avoided.

The starting point is therefore that, if cross-border business restructurings involve transfers of tangible assets, they will fall within the scope of application of the U.S. transfer pricing rules. Consequently, Russian, Finnish and U.S. law have approached the question similarly and do not deviate from each other in this regard. The arm's length principle is thus followed by the target countries in terms of controlled transfers of tangible property in the business restructuring context.

## **3.6 INTANGIBLE ASSETS**

### **3.6.1 GENERAL REMARKS**

In addition to transfers of tangible property, a business restructuring may often involve transfers of intangible assets. For instance, a previously fully-fledged manufacturer may transfer intangible assets used in its former marketing and sales activities, such as trademarks, to a foreign associated company, when it starts operating as a toll-manufacturer after the business restructuring. It is also possible that a business restructuring aims at centralizing all the intellectual properties and R & D activities of a multinational group of companies in one group company, as discussed earlier. This IP company will own all the current intellectual property rights and intangibles of the group, as well as any future intellectual property rights and intangibles arising out of the R & D activities. Such a business restructuring thus involves transfers of the present intangible assets of the group companies to one specific group company operating as an IP company.<sup>304</sup>

The question of whether, and to what extent, transfers of intangible assets in business restructurings shall be subject to transfer pricing regulation is complex. First of all, the concept of intangible asset or property has a broad meaning as it may cover several types of assets. For instance, the concept may refer to the so-called intellectual property rights, like trademarks and patents, but it may also refer to more ambiguous terms, such as goodwill and going concern value. Furthermore, the concept may be understood in various ways in different countries, which may lead to some assets not be considered as intangibles falling within the scope of application of the national transfer

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<sup>304</sup> Kroppen – Silva 2011, p. 57.



pricing provisions in some countries. In other countries, the same assets may be regarded as intangible properties, to which transfer pricing rules should be applied.

Second, some intangible assets lack the ability of being distinguished from other (intangible) assets, and therefore it is unclear whether they can be transferred in a business restructuring separately at all, if the restructuring does not involve a transfer of a functioning business unit, a going concern. This can be the case, for example, when the potential transfer of goodwill during the business restructuring is explored.<sup>305</sup>

The OECD has recently paid increasing attention to related party transactions involving transfers of intangible assets in general. Chapter VI of the OECD Transfer Pricing Guidelines, which deals with the transfer pricing aspects of intangibles, was in the past often criticized and considered outdated, as the guidelines failed to mention, for a long time, goodwill and going concern value as intangible assets subject to transfer pricing, for instance.<sup>306</sup> Now, Chapter VI has undergone several amendments as a result of the BEPS Project, and the concept of intangible asset has been extended to meet the today's needs in the transfer pricing context.<sup>307</sup> These changes, especially the updated concept of intangible asset, will be discussed more closely later on.

As discussed, Finnish law follows the OECD's transfer pricing guidance to a great extent and has not restricted the application of transfer pricing provisions to certain types of transactions; pursuant to the preliminary works and the Finnish Tax Administration's guidance, intangible assets fall generally within the scope of national transfer pricing provisions.<sup>308</sup> Likewise, the U.S. transfer pricing provisions are applicable to controlled transfers of intangible property as the only legislated transfer pricing provision, Section 482 of the IRC, expressly mentions transfers of intangibles as a transaction type subject to transfer pricing, and the Treasury Regulations contain extensive provisions as regards transfer pricing of intangibles.<sup>309</sup> Although intangible assets fall

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<sup>305</sup> Cordova – Mitra – Newman – Reams – Shanda – Shapiro 2012, p. 47. Transfers of goodwill will be discussed in more detail in Section 3.6.5.

<sup>306</sup> See more about the criticism in Silberstein 2011, pp. 1–6.

<sup>307</sup> See more about the project in the OECD Scope of the OECD Intangibles Project, OECD Revised Discussion Draft on Transfer Pricing Aspects of Intangibles and OECD Action Plan on BEPS. The newest OECD guidance in relation to the transfer pricing of intangibles was introduced in 2015 in the OECD BEPS Actions 8–10.

<sup>308</sup> See HE 107/2006 vp, p. 20. See also Finnish Tax Administration Memorandum 1471/37/2007, pp. 24 and 37. Similar views have also been presented in the legal literature; see e.g. Laaksonen 2014a, pp. 163–181, Linnanvirta – Rapo 2012, pp. 272–279.

<sup>309</sup> See Treas. Reg. § 1.482-4(b).

generally within the scope of the Finnish and the U.S. transfer pricing rules, the concept of intangible property in transfer pricing is not entirely clear and straightforward. Consequently, the question of to what extent intangibles fall within the scope of the transfer pricing rules (especially in business restructurings) is thus at least to some extent ambiguous and may cause interpretive problems. This question will be dealt with in more detail in this chapter.

The question of whether transfers of intangibles are objects of transfer pricing is considerably more problematic in Russia. According to the Tax Code, transfer pricing regulations are applied only to related party transactions where *commodities, services and/or work* are transferred from one related party to another. As the interpretation of Russian law is based on legislated legal norms in essence in the earlier mentioned manner, it is very difficult to validate an argument according to which transfers of intangible assets would in general fall within the scope of the Russian transfer pricing regulations.

On the other hand, when the Tax Code's new transfer pricing rules were introduced, the Minfin published written clarifications as to the interpretation and application thereof in practice. According to the written clarifications, transfers of *intellectual properties* are subject to transfer pricing regulations.<sup>310</sup> As mentioned above, the Minfin's clarifications are not legally binding but rather informative and clarifying by nature. Taxpayers and tax authorities are not obliged to obey the written clarifications.<sup>311</sup> Furthermore, it is worth to mention that the former transfer pricing rules and the practice related to their application did not authorize the authorities to intervene in the pricing of transfers of intangibles, as the scope of transfer pricing provisions was deemed to concern only transactions involving transfers of work, commodities and services<sup>312</sup> — as also regulated in the newest provisions of the Tax Code.

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<sup>310</sup> Raz'yasneniya Ministerstva Finansov Rossijskoj Federatsii po voprosam primeneniya razdela V.I Nalogovogo kodeksa Rossijskoj Federatsii. The current written clarifications can be found at [http://www.nalog.ru/rn77/taxation/transfer\\_pricing/minfin\\_v1/](http://www.nalog.ru/rn77/taxation/transfer_pricing/minfin_v1/).

<sup>311</sup> Article 34.2 of the Tax Code. See also the Minfin's letter Pis'mo ot 7 avgusta 2007 g. N 03-02-07/2-138 Raz'yasneniya polozhenij nalogovogo zakonodatel'stva v chasti stat'i 34.2 Nalogovogo kodeksa RF and the Supreme Commercial Court's decision Postanovlenie Prezidiuma VAS RF ot 16.01.2007 N 12547/06 "Ob ostavlenii bez izmeneniya opredeleniya VAS RF ot 24.08.2006 N 8519/06, kotorym bylo prekrashcheno proizvodstvo po delu o priznanii nedejstvuyushimi pisem Minfina RF ot 05.08.2004 N 01-02-01/03-1625, ot 22.03.2006 N MM-6-21/304@."

<sup>312</sup> See e.g. Postanovlenie FAS Volgo-Vyatskogo okruga N A79-806/2005 ot 19.09.2005. See also Wright T. 2007a, p. 90.

Nevertheless, the written clarifications can be very useful in practice as they usually provide interpretive help in relation to the Tax Code's sometimes very complicated regulations. Usually, it is reasonable for taxpayers to comply with the written clarifications, as it is not easy to forecast when the authorities are willing to follow the clarifications and *vice versa*. From this perspective, it would be rational to interpret the Russian transfer pricing rules in a way, which would result in that at least transfers of intellectual property rights would be subject to transfer pricing in business restructurings. This approach has been supported by several commentaries of Chapter V.1 of the Tax Code.<sup>313</sup> In addition, tax practitioners are of the opinion that the newest transfer pricing regulations should be applied to transfers of intellectual property rights.<sup>314</sup>

Finally, the FTS has also shared the Minfin's interpretation in its letter dated 6 March 2014,<sup>315</sup> and therefore it is now beyond dispute that the FTS itself interprets the transfer pricing provisions so that controlled transfers of intellectual properties fall within the scope of the Russian transfer pricing regulations. Hence, it is also reasonable for taxpayers to follow the aforesaid Minfin's and the FTS's guidance in this regard (i.e. to treat transfers of intellectual properties as objects of transfer pricing) to avoid potential disputes with the tax authorities. This view can also be justified when taking into account the above-discussed considerations and that no conflicting interpretations have been published on the question by Russian courts or other relevant sources. This interpretation can be, in the end, also validated by referring to the arm's length principle: It is self-evident that independent parties would compensate the sale and purchase of intellectual properties, such as patents and trademarks. When controlled transfers of intellectual property fall in the above-mentioned manner, also within the scope of the Tax Code's transfer pricing provisions, related parties are put commercially in the same position as independent parties.

Yet, it is problematic that such an essential question as the applicability of the transfer pricing rules to transfers of certain intangibles has been disregarded in the Tax Code's transfer pricing provisions entirely and is subject to

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<sup>313</sup> See e.g. Vasutin – Kosheleva 2012, p. 1; Kaftannikov 2011, pp. 15–16. It should be noted that some commentaries have not even regarded the narrow wording of the scope of application of transfer pricing rules troublesome, and controlled transfers of intangible assets have been deemed to be targets of transfer pricing in general (not limited to transfers of intellectual properties), see e.g. Hellevig – Usov – Kabakov 2014, p. 215. This approach is nonetheless troublesome due to the lack of support from the legislated provisions as well as the Minfin's and the FTS's written clarifications and letters.

<sup>314</sup> Expert Interview 2012.

<sup>315</sup> Pis'mo Federal'noj nalogovoj sluzhby ot 6 marta 2014 g. N ZN-3-13/878@ O primenении položenij razdela V.I NK RF. The FTS mentions as examples of properties subject to transfer pricing patents, trademarks, licenses and copyrights.

interpretation. As the interpretation of Russian law should primarily be based on legal norms, such a relevant issue as the transfer pricing of intellectual properties should be in the first place dealt with in the Tax Code's provisions. Furthermore, regardless of the fact that Article 32 of the Tax Code gives the tax authorities the right to publish written information on tax legislation and rights and liabilities arising thereof, the legal status of such written information corresponds to the legal status of the Minfin's written clarifications. The FTS's letters are thus not legally binding in nature, although they may provide useful interpretations of ambiguous provisions of the tax legislation. Importantly, since the FTS's letters are not considered legal norms, they do not amend or revoke existing tax provisions.<sup>316</sup> This means that the Minfin's and the FTS's prevailing interpretation (i.e. intellectual properties are considered objects of transfer pricing) must be ultimately incorporated into the Tax Code.

Why the Minfin and the FTS have only dealt with the applicability of the transfer pricing rules *to controlled transfers of intellectual properties* and not to *intangible assets in general* may also be criticized. In light of the current Tax Code's provisions, no reasons are evident why the authorities have come to the conclusion that controlled transfers of intellectual properties fall within the scope of the Tax Code's transfer pricing rules, while the applicability of the rules to transfers of intangibles generally remain unconsidered and undiscussed. As the newest transfer pricing rules are widely based on the OECD Transfer Pricing Guidelines, it is unclear why the Minfin and the FTS have taken such an approach, where they only partly follow the guidelines (instead following entirely or not following at all). As a result, a certain degree of ambiguity exists regarding whether intangibles other than intellectual properties may be subject to transfer pricing in Russia. As the Minfin and the FTS have only discussed transfers of intellectual properties, and when also taking into consideration the above-mentioned other considerations, transfers of other intangibles than intellectual property seem to fall outside the scope of the Tax Code's transfer pricing provisions. This, in turn, creates problems from the perspective of the arm's length principle, as other intangibles may also have commercial value that would be compensated in transactions between independent parties. Consequently, related and independent parties could be treated differently, which is contrary to the whole purpose of the arm's length principle.

Overall, from a business restructuring perspective, the above stated interpretation — which should be taken as the starting point in this study —

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<sup>316</sup> The Minfin's letter Pis'mo Minfina RF ot 1 dekabrya 2009 g. N 03-05-05-05/11 and order Prikaz Minfina Rossii ot 15.06.2012 N 82n (red. ot 29.11.2013) "Ob utverzhdenii Reglamenta Ministerstva finansov Rossijskoj Federatsii."

means that at least transfers of intellectual properties occurring in the course of a business restructuring fall within the scope of application of the Russian transfer pricing rules. This requires that such transfers can also be separated from other possible transfers in the restructuring and that these kinds of transfers would be compensated in transactions performed between independent parties. Conversely, the current situation regarding whether transfers of other intangible assets may become objects of transfer pricing in the business restructuring context in Russia is unclear. As it is very common in business restructurings that also other types of intangible assets — not only intellectual property rights — are transferred between group companies, the current legal situation is very troublesome.

Subsequently, the question of to what extent intangible assets may fall within the scope of application of the transfer pricing rules in Russia, Finland and the USA as separate asset transfers will be dealt with in more detail. Before discussing transfers of intangibles on an asset-by-asset basis, it is useful to examine briefly how the ownership of intangible assets is determined pursuant to the national laws of the target countries.

### **3.6.2 OWNERSHIP OF INTANGIBLE ASSETS**

It is important to understand which related party owns the transferred intangible asset in a controlled transaction and is ultimately entitled to an arm's length compensation. It is rarely difficult to determine the owner of a tangible property due to the physical nature of the property. For intangible assets, the situation is quite the contrary. The ownership of an intangible property cannot be identified in such a straightforward way, thus it may also be difficult to identify possible transfers of intangibles in a related party transaction. Hence, it is no wonder that in the transfer pricing practice, three different forms of owning intangible assets have been developed, which are used in the determination of ownership of intangibles in controlled transactions for transfer pricing purposes.

The question of how to determine the ownership of an intangible property can be first examined strictly from the legal perspective. The *legal owner* of an intangible asset is the company, which has been defined as the owner of the intangible asset pursuant to the national legislation. Usually, the legal owner is the company to which the asset, for example a trademark, is registered. The *economic owner*, on the other hand, is the company that has invested the most in the creation of an intangible property and carried the most risks involved in its development.<sup>317</sup> The third form of ownership relates to the exploitation of

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<sup>317</sup> Markham 2005, p. 45.

an intangible property and the general benefits arising from it. In that case, the owner is called the *beneficial owner* of an intangible asset, which is usually the company that receives the most benefits attributable to the intangible asset. It may be the same company, which is regarded as the legal owner, or it can be another company that is able to benefit from the property, for example, through a license agreement.<sup>318</sup>

Because the intangible assets have not been subject to transfer pricing in the past in Russia, the questions in relation to the ownership or the identification of intangible assets in the transfer pricing context have not been particularly topical in the legal literature.<sup>319</sup> For the purposes of identifying the owner of an intangible asset, the approach based on the legal ownership seems to be the most appropriate in Russian transfer pricing. This is due to the fact that the right to achieve legal protection for intellectual properties is quite extensively regulated in the legislation in Chapter IV of the Russian Civil Code. Furthermore, the legal protection for most of the intellectual properties may be usually achieved in Russia only by registering the assets in the national register. For example, trademarks and patents, as well as many other intellectual property rights, should primarily be registered in the state-owned register in order to gain legal protection.<sup>320</sup> The register is maintained by the Federal Service for Intellectual Property ROSPATENT (hereinafter the “Rospatent”).<sup>321</sup>

This view is justified from the perspective of the dominant position of written legislated provisions in the hierarchy of the sources of Russian law. As legal questions are generally approached by interpreting and applying legislated provisions, legal facts cannot usually be ignored by referring to special conditions of a certain case, if such conditions have not been regulated in the legislation. For instance, it is very unlikely to have legal grounds for considering a company as the actual owner of an intangible asset on the basis of that the company has invested in the development process of the asset or that the company receives benefits attributable to the intangible asset, if another company has been registered as the legal owner of the intangible property in the Rospatent’s registers pursuant to the legislated provisions. Hence, in business restructurings, the starting point should be the examination of whether the restructured entity is the (registered) legal owner

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<sup>318</sup> Karjalainen – Raunio 2007, pp. 163–165.

<sup>319</sup> The problems related to identifying the owners of such assets have been recognized in some Russian publications, but concrete proposals for solving the problems have not been presented, see e.g. Azgaldov – Karpova 2006, p. 31.

<sup>320</sup> Articles 1393 and 1503 of the Russian Civil Code. See also Article 1232 of the Civil Code, which is the general article regulating the registration of intellectual property rights under Russian law.

<sup>321</sup> Orlov 2010, pp. 295 and 299.

of certain intellectual properties, which could be used in its restructured business activities, and whether it has transferred some of the assets as a result of the restructuring to another group company. For this purpose, it may be useful to review, whether any kinds of intangibles have been registered in the Rospatent's registers in the name of the company in question.

Also in Finland, the basis for determining the ownership of intangibles is, at least in some cases, regulated in the legislation. Intellectual property rights — such as trademarks, patents and utility models — have their own acts under which the legal protection and the exclusive rights for such properties are regulated. As a general rule, intellectual property rights must often be registered in the national registers in order to receive exclusive rights and gain legal protection.<sup>322</sup> In this regard, Finnish law is in line with Russian law.

However, the concept of intangible asset or property also covers other kinds of assets than intellectual property. Such assets (and their protection) may not always be legislated under particular acts, and therefore the legal ownership thereof may not be determined on the basis of legislated provisions. In such situations, the OECD Transfer Pricing Guidelines become relevant. The OECD has dealt with the transfer pricing aspects of intangible assets, which are by nature hard to identify or separate from other (intangible) assets. More importantly, in 2015, as a result of the BEPS Project, it published new guidance in relation to the identification of ownership of intangibles for transfer pricing purposes. Pursuant to the OECD Transfer Pricing Guidelines,

“The legal owner will be considered to be the owner of the intangible for transfer pricing purposes. If no legal owner of the intangible is identified under applicable law or governing contracts, then the member of the MNE group that, based on the facts and circumstances, *controls decisions concerning the exploitation* of the intangible and *has the practical capacity to restrict others from using the intangible* will be considered the legal owner of the intangible for transfer pricing purposes.”<sup>323</sup>

It seems that the OECD proposes that the determination of the ownership of intangibles in cases, where the ownership is not legislated and/or agreed in a contract, will be conducted on the basis of the utilization right and general control over the intangible asset in question. On the other hand, the guidelines

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<sup>322</sup> See e.g. Chapter 2 of the Finnish Trademarks Act (*Tavaramerkkilaki*, 7/1964), § 20 of the Finnish Patents Act (*Patenttilaki*, 550/1967) and § 17 of the Finnish Act on Utility Model Rights (*Laki hyödyllisyyksmallioikeudesta*, 800/1991). This has been noted also in the OECD Transfer Pricing Guidelines; see OECD Transfer Pricing Guidelines, 6.37.

<sup>323</sup> OECD Transfer Pricing Guidelines, 6.40.

also mention the importance of analyzing all the circumstances of a given case. According to the OECD Transfer Pricing Guidelines, “legal ownership and contractual relationships serve simply as reference points for identifying and analysing controlled transactions relating to the intangible and for determining the appropriate remuneration to members of a controlled group with respect to those transactions. Identification of legal ownership, combined with the identification and compensation of relevant functions performed, assets used, and risks assumed by all contributing members, provides the analytical framework for identifying arm’s length prices and other conditions for transactions involving intangibles.”<sup>324</sup> Thus, the determination of a legal owner of intangible assets does not indicate that the legal owner is alone or at all entitled to an arm’s length compensation.<sup>325</sup>

The discussed OECD’s provisions suggest that the ownership of intangible assets may be defined on the basis of the legal ownership, i.e. on the basis of legislated provision and/or agreements, as a starting point. As the legal ownership cannot always be clearly identified due to the lack of legal provisions/agreements or the legal ownership does not always bring the best result from the transfer pricing perspective, other conditions must be taken into account. In that case, it must be examined, which party has the actual control over the intangible asset, the exploitation rights arising from the intangible asset as well as what functions have been performed and risks assumed by the related parties in a transaction involving the intangible asset. Consequently, this means that the identification of the economic or beneficial owners of intangible assets may be required in some cases for transfer pricing purposes, although such concepts have not been expressly used in the OECD Transfer Pricing Guidelines.

As Finland generally follows the OECD Transfer Pricing Guidelines, the new provisions regulating intangible ownerships are likely to be followed in Finland too. This approach is not in conflict with the current legal state in Finland. As it was earlier mentioned, the intellectual property rights are to a large extent regulated in the Finnish legislation, and therefore the ownership of an intellectual property can primarily be identified pursuant to the legislated provisions for transfer pricing purposes. In addition, all the three forms of intangible ownerships have been recognized in the Finnish legal literature, and especially the importance of understanding the economic owner of an intangible asset in the transfer pricing context has been highlighted.<sup>326</sup> Thus, in accordance with the OECD Transfer Pricing

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<sup>324</sup> OECD Transfer Pricing Guidelines, 6.43.

<sup>325</sup> OECD Transfer Pricing Guidelines, 6.47.

<sup>326</sup> See e.g. Karjalainen – Raunio 2007, p. 164; Hintsanen – Karjalainen 2007, p. 240. See also Jaakkola et al. 2012, pp. 207–208.



Guidelines, the starting point for the determination of ownership of an intangible asset should be as follows: at first, the legal ownership should be identified, but attention must be paid also to other circumstances of the case in question, such as commercial exploitation, control and functions performed/risks assumed in the given transaction. If the legal ownership cannot be determined or would not bring the best result in terms of the arm's length principle, more weight should be given to the other factors.

The Finnish approach therefore deviates from the Russian approach in this respect, as the sources of Russian law do not currently support a view according to which other forms of intangible ownerships than the legal ownership could be considered possible for transfer pricing purposes. On the other hand, when a related party transaction involves transfers of intellectual properties, it is likely that the legal ownership is the determining factor also in Finland.

As opposed to Finnish and Russian law, the ownership of intangible assets has been regulated in the U.S. Treasury Regulations specifically for transfer pricing purposes. As was the case in Russia and Finland, the starting point is to identify the legal owner of an intangible property; the legal owner of the intangible property identified in accordance with applicable intellectual property laws, contractual terms or other legal provisions will primarily be deemed as the sole owner of the intangible property for the purposes of transfer pricing.<sup>327</sup>

However, the Treasury Regulations also contain exceptions by which this assumption may be disregarded. First, if the legal ownership is “inconsistent with the *economic substance* of the underlying transactions,” the legal ownership of intangibles may be ignored.<sup>328</sup> As such, the contractual terms of the transactions in question must be identified and reviewed. In general, when the economic substance of a written agreement is under examination, in addition to the respective legal rights of the parties, the actual conduct of the parties is of great importance. If the contractual terms are inconsistent with the economic substance of the transactions, such terms may be disregarded and other terms, which are in line with the economic substance of the transactions, may be imputed.<sup>329</sup>

Moreover, in case the legal owner of an intangible asset cannot be identified on the basis of intellectual property laws or contractual terms, the related party “who has *control* of the intangible property, based on all the facts and

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<sup>327</sup> Treas. Reg. § 1.482-4(f)(3)(i)(A).

<sup>328</sup> Ibid.

<sup>329</sup> Treas. Reg. § 1.482-1(d)(3)(ii)(B).

circumstances, will be considered the sole owner of the intangible property” for the transfer pricing purposes.<sup>330</sup> For instance, where a subsidiary of a foreign parent company has developed a list of customers, and neither the terms and conditions of the agreement between the subsidiary and the parent company, nor the relevant intellectual property law regulate which party can be regarded as the owner of the customer list, the subsidiary shall be considered the sole owner of the customer list due to the fact that it knows the content of the list and has practical control over its use.<sup>331</sup>

The U.S. provisions dealing with the ownership of intangibles in the transfer pricing context seem to have taken a largely similar approach as the OECD Transfer Pricing Guidelines and Finnish law. First, it must be examined whether the legal owner of intangibles can be identified in a controlled transaction. When the identification of the legal owner is possible, the legal owner shall be, as a general rule, considered the sole owner of the intangible asset. On the other hand, if there are no applicable acts or agreements, under which the owner of an intangible asset could be identified, other factors and circumstances — in U.S. law, the practical control — will be taken into account in the determination of the ownership.

Nonetheless, it must be observed that the OECD Transfer Pricing Guidelines require taxpayers to also identify other factors, in the above-mentioned manner, which may affect transfer pricing of transaction — such as functions performed and risks assumed by the related parties — even in situations where the legal owner of an intangible asset may be identified. Thus, such economic factors may result in the legal ownership being ignored, and the economic owner that assumes all the risk may be entitled to the arm’s length compensation partially or even entirely. On the contrary, the possibility to regard economic owners as the sole owners of intangibles for transfer pricing purposes under the Treasury Regulations is restricted to situations where the legal ownership is inconsistent with the economic substance of the transaction involving transfers of intangible assets. Furthermore, other circumstances can be taken into account primarily when the legal owner of an intangible asset cannot be identified on the basis of intellectual property laws or contractual terms. Thus, in contrast to the OECD Transfer Pricing Guidelines, the Treasury Regulations do not contain a similar extensive authorization to consider other factors in order to possibly disregard the legal ownership of intangibles.<sup>332</sup>

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<sup>330</sup> Treas. Reg. § 1.482-4(f)(3)(i)(A).

<sup>331</sup> Treas. Reg. § 1.482-4(f)(3)(ii) Example 1 and Example 2.

<sup>332</sup> It must be noted that the functional analysis and the comparability analysis, however, require that other specific circumstances must also be taken into account when analyzing transfer pricing aspects of

It is useful to note that pursuant to the former Treasury Regulations, the economic ownership was the determining factor when the ownership of intangibles was identified for transfer pricing purposes. Due to a great change in this respect, the newest provisions that regulate the legal ownership as the overriding approach have been criticized. In particular, it has been considered ambiguous in the legal literature, how the transfer pricing rules should be applied in situations where the legal owner of an intangible property and the economic developer are not the same legal person.<sup>333</sup> Nevertheless, it is still possible under present regulations to regard taxpayers as economic owners of intangibles for transfer pricing purposes in the aforementioned manner, and therefore the U.S approach is ultimately more similar to the OECD Transfer Pricing Guidelines (and Finnish law) than Russian law, where the ownership of intangible assets for transfer pricing purposes may be basically identified solely on the basis of the legal ownership.

### 3.6.3 INTELLECTUAL PROPERTY RIGHTS

Some intangible assets are, to a large extent, universally protected, and therefore they may achieve legal protection under both national legislation and international treaties. These kinds of intangibles are called intellectual property rights, which are traditionally divided into: (i) copyrights and other rights related to copyrights; and (ii) industrial property. The former includes written and artistic creations, such as novels and paintings, while the latter refers to, among other things, patents, trademarks, utility models, designs and layout designs (topographies) of integrated circuits.<sup>334</sup> It is common that intellectual property rights are transferred in the course of business restructurings from one related party to another group company.<sup>335</sup> Especially transfers of industrial property, such as assets used in the manufacturing or

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controlled transactions of intangibles and determining the arm's length compensations for the such transactions in the USA, see Sections 3.3 and 4.2 of this study.

<sup>333</sup> The former regulations started from the assumption that the owner of intangible assets was the party, which has borne the majority of the costs in relation to the development of such intangibles, and thus the economic ownership had to be considered primarily for transfer pricing purposes; see e.g. Markham 2005, p. 49. See also decisions *DHL Corp. v. Commissioner*, 285 F.3d 1210 (9th Cir. 2002) and *GlaxoSmithKline Holdings (Americas) Inc. v. Commissioner*, Tax Court Docket Nos. 5750-04 and 6959-05 (2006), where the economic ownership of the so-called marketing intangible assets was discussed and accepted for transfer pricing purposes. See more about the cases in Wittendorff 2010a, p. 639 and Levey – Eisen 2009, pp. 557–558.

<sup>334</sup> Haarmann 2014, pp. 3–5; Haarmann – Mansala 2012, pp. 15–17.

<sup>335</sup> OECD Transfer Pricing Guidelines, 9.55.

marketing activities (e.g. patents and trademarks) of a restructured entity, may become relevant in business restructurings.<sup>336</sup>

The OECD Transfer Pricing Guidelines have provided examples with regard to business restructurings, which involve transfers of intellectual property rights. A multinational enterprise may have justified business reasons to centralize all of the group's intangibles in one IP company. Before the contemplated restructuring, local manufacturing companies may own all the patents used in their manufacturing activities in their jurisdictions. In order to centralize the management of such patents owned by local companies, the patents need to be transferred to the IP company. As a result of the business restructuring, the IP company will own and take care of the management of the patents in future, while the local manufacturing companies may continue using the patents in their manufacturing activities through contractual arrangements, such as licensing agreements. Alternatively, a business restructuring may be aimed at transferring trademarks, which were initially owned by local companies, to a central location.<sup>337</sup>

As intellectual property rights may be in the aforesaid manner transferred from one related party to another in cross-border business restructurings, it must be examined whether such transfers may fall within the scope of application of the national transfer pricing rules in Russia, Finland and the USA. It was previously discussed that the existing Russian transfer pricing provisions should be interpreted so that at least controlled transfers of intellectual properties should be considered objects of transfer pricing, as set out in the Minfin's and FTS's guidance. However, as mentioned earlier, the legislated Russian transfer pricing provisions do not contain any mention of intangible assets or intellectual properties. Furthermore, the Russian Tax Code does not even hold a general definition of intangible assets or intellectual property in its other chapters, which could be used in determining the concept of intellectual property for taxation and especially for transfer pricing purposes. Only Article 258 of the Tax Code, which regulates the rules of determining the value of amortizable property, contains a list of intangible assets, which are in the scope of the said article for its purposes, but it does not provide help in determining what intangible assets are recognized as intellectual property rights pursuant to Russian tax law.<sup>338</sup>

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<sup>336</sup> Such assets are often transferred also in business transfers conducted between independent parties; see e.g. Mehtonen 2001a, p. 185.

<sup>337</sup> OECD Transfer Pricing Guidelines, 9.57–9.58.

<sup>338</sup> The list mentions, inter alia, patent holders' exclusive rights to inventions, industrial designs and utility models; authors' exclusive rights to computer software and databases; and exclusive rights to trademarks, service marks and company names.

Consequently, the general rules regulating the intellectual property rights in Russia must be examined. The intellectual properties safeguarded by Russian law are regulated in Chapter 7 of the Russian Civil Code. According to Article 1225 of the Civil Code, *inter alia*, works of science, literature and art, computer programs/software, databases, inventions, utility models, industrial designs, topologies of internal microcircuits, brands, company names, trademarks, service marks and commercial signs are intellectual properties protected by law. Moreover, pursuant to the Civil Code, a patent can be applied for inventions, utility models and industrial designs.<sup>339</sup>

The list is considered exhaustive, and intangible properties that have not been listed in the said article cannot be regarded as intellectual properties under Russian law.<sup>340</sup> It must be noted that Russia is also a signatory to international treaties regarding the protection of intellectual property rights, such as the Convention Establishing the World Intellectual Property Organization (WIPO Agreement) and the Agreement on Trade-Related Aspects of Intellectual Property Rights (TRIPS Agreement).<sup>341</sup> The international treaties are binding upon Russia, and they have priority over Russian national legislation.<sup>342</sup> Nonetheless, it should be observed that the legal protection of intellectual property rights in Russia is extensive and comparable to Western countries. Intellectual property rights that are commonly transferred in business restructurings — for example, trademarks, copyrights and patents — are also recognized and protected as intellectual property rights pursuant to Russian law. More importantly, the FTS mentions in the aforementioned letter as examples of intellectual properties, which it regards as objects of transfer pricing, patents, trademarks, licenses and copyrights.<sup>343</sup> Therefore, the FTS's understanding of the concept of intellectual properties for transfer pricing purposes is in line with the Civil Code's provisions.

As stated above, when examining whether certain assets should be considered objects of transfer pricing in a business restructuring, it should also be reviewed whether transfers of such assets can be identified and separated from other potential transfers of assets/something of value conducted in the course of a business restructuring.<sup>344</sup> Transfers of intellectual property rights can be usually identified and separated from other asset transfers as, for instance,

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<sup>339</sup> Article 1345 of the Civil Code.

<sup>340</sup> Borisov 2014, p. 845.

<sup>341</sup> See more in e.g. Moskalev 2009, pp. 34–37.

<sup>342</sup> Article 15 of the Constitution of the Russian Federation; Article 7 of the Civil Code.

<sup>343</sup> Pis'mo Federal'noj nalogovoj sluzhby ot 6 marta 2014 g. N ZN-3-13/878@ O primenenii polozhenij razдела V.I NK RF.

<sup>344</sup> This is the case in Russia. Under Finnish and U.S. rules, such assets may also be transferred as a part of a functioning business unit, as dealt with earlier.

many of the intellectual properties must be registered to achieve legal protection in Russia.<sup>345</sup> It is relatively easy to obtain information on possible intellectual properties owned by the restructured company in question or other group companies involved in the restructuring from the registers maintained by Rospatent, which in turn will help to identify whether such properties have been transferred in the course of the business restructuring.

In addition, in order to become objects of transfer pricing, intellectual properties should have commercial value that would be compensated in transactions between independent parties. Patents, trademarks, utility models and other intellectual property rights clearly have this kind of commercial value. Their transfers usually generate profits,<sup>346</sup> and therefore intellectual properties cannot primarily be transferred without being remunerated.

Thus, taking into account the above, as well as the earlier-mentioned written clarifications by the Minfin and the FTS's letter, if cross-border business restructurings involve transfers of intellectual property, such transfers will primarily fall within the scope of application of the Russian transfer pricing regulations in the current legal state. As mentioned, in this circumstance, the concept of intellectual property includes such intangible assets as trademarks, designs and patents, which are also universally understood as intellectual properties. Albeit this conclusion can be reached quite easily from the aforesaid legal sources, the existing transfer pricing rules can be still criticized. As previously discussed, the fact that the interpretation of this question is in principle based on the FTS's and Minfin's written clarifications and guidance is problematic. The dominant position of the legislated legal norms in the hierarchy of the Russian legal sources requires that the applicability of the transfer pricing rules to transfers of intellectual property should be regulated in the Tax Code. It would be of great importance also to determine *de lege ferenda* in the legislation, how the concept of intellectual property should be understood in the transfer pricing context. This could be implemented, for instance, by defining the concept specifically for transfer pricing/tax purposes in the Tax Code's provisions or by referring in the provisions to the Civil Code's respective provisions.

In Finland, the starting point is that intangible assets should in general fall within the scope of application of the transfer pricing provisions, as the scope is not limited to particular types of assets or transactions in the above-mentioned manner. The preliminary works specifically mention that related party transactions involving transfers of intangibles fall within the scope of §

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<sup>345</sup> As mentioned earlier, among other things, patents and trademarks must be registered in the state register, which is maintained by Rospatent.

<sup>346</sup> De Robertis – Matthias – Damian 2006, p. 17; Haarmann – Mansala 2012, pp. 16–17.

31 of the AAP.<sup>347</sup> Although the preliminary works have not defined the concept of intangible asset in this particular paragraph, there is a strong assumption that transfers of intellectual property rights should, as being intangible assets by nature, be subject to the Finnish transfer pricing rules strictly on these grounds. This view may be supported by the fact that the preliminary works expressly mention some assets, which are generally considered intellectual properties, as forms of intangible assets in other parts of the preliminary works. For instance, when the functional analysis is discussed, trademarks, patents and designs are specifically mentioned as examples of intangible assets.<sup>348</sup> This may be naturally applied also to § 31 of the AAP.

In addition, the Finnish Tax Administration's memorandum regarding the transfer pricing documentation clarifies the question greatly. Pursuant to the memorandum, trademarks, patents and designs, for example, are forms of intangible assets. Moreover, the concept of intangible asset should be understood broadly, and therefore it covers also other forms of (intangible) assets, which generate profit, although they cannot be registered or they are not assignable. Hence, technology, customer lists, distribution channels and other similar assets must also be understood as intangible assets for transfer pricing purposes.<sup>349</sup> As the concept of intangible asset is in this sense defined broadly, the intellectual property rights — which can be usually quite easily registered and assigned — meet the criteria of the said definition effortlessly. From this perspective, the intellectual property rights should be regarded as intangible assets subject to the Finnish transfer pricing provisions.

More legal support for the aforementioned view can be found from the OECD Transfer Pricing Guidelines. As the guidelines are followed and applied in the Finnish practice to a great extent, Chapter VI of the OECD Transfer Pricing Guidelines, which deals with the transfer pricing aspects of intangibles in detail, must be reviewed. According to the recently renewed provisions, the concept of intangible “is intended to address something which is not a physical asset or a financial asset, which is capable of being owned or controlled for use in commercial activities, and whose use or transfer would be compensated had it occurred in a transaction between independent parties in comparable circumstances.”<sup>350</sup> The term is thus understood very broadly, and the approach is equivalent to the Finnish Tax Administration's approach. The guidelines do not, nonetheless, try to define the concept of intellectual property for transfer pricing purposes in more detail, although particular intangible assets, which are universally considered intellectual property rights,

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<sup>347</sup> See HE 107/2006 vp, p. 20.

<sup>348</sup> HE 107/2006 vp, p. 16.

<sup>349</sup> Finnish Tax Administration Memorandum 1471/37/2007, p. 24.

<sup>350</sup> OECD Transfer Pricing Guidelines, 6.6.

are mentioned specifically in certain paragraphs of Chapter VI of the OECD Transfer Pricing Guidelines. For example, copyrights,<sup>351</sup> trademarks and trade names<sup>352</sup> as well as patents<sup>353</sup> have been regarded as intangibles subject to transfer pricing and the arm's length principle.

It should be observed that the concept of intellectual property under Finnish law is equivalent to the universal understanding of the concept, as Finland is a signatory state to the main international treaties regulating the intellectual property rights, similar to Russia.<sup>354</sup> Consequently, the intellectual property rights mentioned in the OECD Transfer Pricing Guidelines, such as patents and trademarks, are understood similarly under Finnish law. The intellectual property rights and the legal protection thereof are usually legislated in national acts, and Finnish law offers no exception. For instance, copyrights,<sup>355</sup> trademarks,<sup>356</sup> patents,<sup>357</sup> utility models<sup>358</sup> and other common intellectual property rights gain legal protection through own particular acts in Finland.

Taking into consideration the previously mentioned observations, clear legal support can be found for the view that transactions involving transfers of intellectual property rights fall within the scope of the Finnish transfer pricing provisions. As discussed, apart from falling within the scope of application of the national transfer pricing provisions, transfers of intellectual property rights can be usually quite easily identified and distinguished from other possible transfers occurring in the business restructuring; furthermore, such transfers commonly create value that would be remunerated in transactions conducted between independent parties in comparable circumstances. As a result, when a cross-border business restructuring involves transfers of intellectual properties, such transfers are subject to transfer pricing. Consequently, such transfers must be compensated in accordance with the arm's length principle separate from other possible asset transfers, when the restructuring does not involve a transfer of a going concern.

In this respect, the existing legal situation in Finland conforms to a great extent to the situation in Russia. The concept of intellectual property under both countries' laws covers similar assets, and transfers of such assets fall within the scope of the national transfer pricing rules in the business

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<sup>351</sup> See e.g. OECD Transfer Pricing Guidelines, 6.37.

<sup>352</sup> See e.g. OECD Transfer Pricing Guidelines, 6.21–6.22.

<sup>353</sup> See e.g. OECD Transfer Pricing Guidelines, 6.19.

<sup>354</sup> Haarmann 2014, pp. 8–22.

<sup>355</sup> The Finnish Copyrights Act (*Tekijänoikeuslaki*, 404/1961).

<sup>356</sup> The Finnish Trademarks Act (*Tavaramerkkilaki*, 7/1964).

<sup>357</sup> The Finnish Patents Act (*Patenttilaki*, 550/1967).

<sup>358</sup> The Finnish Act on Utility Model Rights (*Laki hyödyllisyysmallioikeudesta*, 800/1991).



restructuring context. On the other hand, as business restructurings may be regarded as transfers of a going concern in some cases in Finland, intellectual properties may not necessarily always be objects of transfer pricing as separate items, but as a part of the going concern. This cannot be the case in Russia.

Moreover, similar interpretive problems that exist in Russia are avoided in Finland. Pursuant to the Finnish legal sources, it is self-evident that intellectual properties can be considered intangible assets, which in turn generally fall within the scope of the transfer pricing rules. A broad definition of intangible property for transfer pricing purposes, which does not aim at determining all the asset types falling within the scope of the concept, brings thus good results in terms of the arm's length principle. In Russia, this question is relatively more ambiguous. The approach used in Finland cannot currently be applied in Russia, as it seems that only intellectual properties fall within the scope of the Tax Code's transfer pricing provisions at present, and not intangibles in general, it would make more sense to determine in the earlier mentioned manner in the transfer pricing provisions *de lege ferenda* the intangible assets that must be understood as intellectual properties for transfer pricing purposes. That would bring more clarity to the current state in Russia.

Contrary to Russian and Finnish law, intangible properties falling within the scope of the U.S. transfer pricing rules are regulated in more detail in the U.S. sources of law. Regardless of that Section 482 of the IRC specifically refers to transactions concerning transfers of intangible property, it does not provide a definition of intangible property for transfer pricing purposes. On the other hand, the section contains a reference to Section 936(h)(3)(B) of the IRC as to the meaning of term 'intangible property', and therefore the definition of intangible property in the said section should be followed also for the purposes of Section 482 and thus for the purposes of transfer pricing.

Pursuant to Section 936(h)(3)(B) of the IRC, the term "intangible property" means, among other things, any *patent, invention, design, copyright, literary, musical or artistic composition, trademark, trade name or any similar item*, which has substantial value independent of the services of any individual. Although the list is comprehensive, it is not exhaustive. It is important to observe that this definition of intangible property is also followed in the Treasury Regulations that interpret Section 482 of the IRC.<sup>359</sup>

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<sup>359</sup> See Treas. Reg. § 1.482-4(b). The definition in the Treasury Regulations, however, differs from the Section 936(h)(3)(B)'s definition in one small respect: the wording "any similar item" in Section 936(h)(3)(B) is replaced in the Treasury Regulations with the wording "other similar items," and an item is considered similar for the purposes of Section 482, if "it derives its value not from its physical attributes but from its intellectual content or other intangible properties."

The concept of intangible asset for transfer pricing purposes has been hence defined specifically in the U.S. tax legislation in the above-discussed manner. More importantly, this concept particularly covers such intangible assets, which are universally considered intellectual property rights. The concept of intellectual property is also understood in U.S. law similarly as in Russia and Finland.<sup>360</sup> In consequence, it is clear that the U.S. transfer pricing rules must be applied in general to controlled transactions involving transfers of intellectual property. In this sense, U.S. law has thus taken a more straightforward approach as compared to Russian and Finnish law.

From the perspective of business restructurings, this means that the transfers of intellectual properties that are commonly transferred in business restructurings due to changes in the manufacturing or marketing activities of a restructured company — for instance patents, trademarks and designs — should fall within the scope of the U.S. transfer pricing rules, as they are regulated as intangible properties subject to transfer pricing pursuant to Section 936(h)(3)(B) of the IRC and the corresponding Treasury Regulations. This view is justified, when also taking into account that such transfers can be usually, in the above-mentioned sense, identified and distinguished from other possible transfers occurring in the business restructuring. Moreover, such transfers are generally compensated in transactions conducted between unrelated parties, which is why they should be remunerated also in controlled transactions at arm's length.

On the other hand, also in the USA, intellectual properties may be transferred in some business restructurings in conjunction with other interrelated assets that form together a functioning business unit; in such cases, they will not become objects of transfer pricing separately, but a part of the transferred going concern. U.S. law therefore conforms to Finnish law in this regard.

Furthermore, as discussed above, the IRC contains provisions under which transfers of certain assets by a U.S. company to a foreign company may exceptionally be free of taxes. This may be the case if such assets are transferred to a foreign company for the purposes of using them by the foreign company in the active conduct of a trade or business outside the USA.<sup>361</sup> However, this exception cannot be applied to transfers of intangible property

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<sup>360</sup> Among other things, patents, trademarks, copyrights and trade names have been considered as intellectual property rights when the concept of intangible property for transfer pricing purposes has been discussed; see e.g. Snyder 2005, p. 16 and Bossart 2005, p. 68. The USA is also a signatory state to the relevant international treaties as to the protection of intellectual properties, such as the above-mentioned WIPO and TRIPS Agreements.

<sup>361</sup> Section 367(a)(1) and Section 367(a)(3)(A) of the IRC.

(with the meaning of Section 936(h)(3)(B) of the IRC), as they have been entirely excluded from the scope of application of the provision.<sup>362</sup> As Section 936(h)(3)(B) covers in the above-mentioned manner intellectual properties to a great degree, transfers of intellectual properties from a U.S. company to a foreign company are generally taxable transactions. Hence, they are also subject to the arm's length principle, when they occur in controlled transactions.

On the above-mentioned grounds, it is justified to conclude that transfers of intellectual property rights occurred in the course of business restructurings are subject to the U.S. transfer pricing rules and the arm's length principle. This means that when a business restructuring does not involve a transfer of a going concern, transfers of intellectual property rights shall be examined and valued separately from the perspective of the arm's length standard. U.S. law does not therefore deviate from Russian and Finnish law in this regard.

However, when the question is examined in more detail, the U.S. approach conforms more to the existing situation in Finland than in Russia. Both countries recognize the possibility that transfers of intellectual properties are included in the transfer of a going concern when a functioning business unit is transferred in the restructuring. This may in certain circumstances lead to a more reliable arm's length result than what would be achieved by valuing contemporaneous transfers of interrelated assets separately. As the aggregation of transactions is not currently possible in a similar manner in Russia, the compensation paid in the restructuring for transfers of intellectual property may in some cases differ from what would be considered the arm's length result in such situations in Finland and the USA. As discussed, the existing transfer pricing rules in the Tax Code should be amended *de lege ferenda* to better meet the aims of the arm's length principle in this respect.

In addition, the particular question of whether intellectual properties may be objects of transfer pricing has been dealt with by the Finnish and U.S. legal sources in a way that does not allow contrary views on the matter. Therefore, there are no such needs for amendments to the legislation and other legal sources as in Russia, where only non-binding sources have discussed the question — although there are no conflicting views on the matter. Nonetheless, despite the mentioned differences, all the target countries in the end comply with the arm's length principle, when a business restructuring involves transfers of intellectual properties. As such transfers fall within the scope of the national transfer pricing regulations, they must be compensated at arm's length.

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<sup>362</sup> Section 367(d) of the IRC.

### 3.6.4 TRADE SECRETS AND KNOW-HOW

Trade secrets and know-how can be defined as information or a knowledge in a company's possession which benefits the company in its business activities. Unlike the intellectual property rights (such as trademarks and patents), trade secrets and know-how cannot be registered in order to achieve legal protection.<sup>363</sup> It is, however, not that uncommon that a group company transfers some of its trade secrets and/or know-how to another related company during a business restructuring.<sup>364</sup> For example, a fully-fledged manufacturer may transfer trade secrets concerning the company's manufacturing procedures and techniques to a newly established related company, which will start operating as a toll-manufacturer as a result of the restructuring. These trade secrets may enable the new manufacturer to manufacture products in a more cost-efficient way.

In the legal literature, trade secrets and know-how are usually treated as intellectual property rights or as a phenomenon closely linked thereto, but as they differ from traditional intellectual property rights in nature, it is reasonable to discuss them separately. Therefore, in this section it is examined whether controlled transfers of know-how/trade secrets, which occur in the course of a business restructuring, may fall within the scope of national transfer pricing rules as separate items in Russia, Finland and the USA.

In Russia, trade secrets and know-how have been increasingly regarded as synonyms.<sup>365</sup> In order that trade secrets and know-how could be considered objects of transfer pricing under Russian tax law, they must be first protected as intellectual property according to the provisions of the Russian Civil Code. This requirement is the consequence of the earlier-discussed Minfin's written clarification and the FTS's letter, under which transfers of intellectual properties were deemed objects of transfer pricing. Pursuant to Article 1225 of the Civil Code, trade secrets (know-how) are protected as intellectual properties in conjunction with other intellectual properties. Any industrial, technical, commercial, organizational or other type of information, which concerns the results of intellectual activity in the field of technology and science as well as information concerning methods of professional activity, may constitute trade secret/know-how. This kind of information can be protected as trade secret, if it has real or potential commercial value on account of not being known to third parties; the information is not freely accessible by third parties pursuant to law; and the holder of such know-how

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<sup>363</sup> See e.g. OECD Transfer Pricing Guidelines, 6.20.

<sup>364</sup> OECD Transfer Pricing Guidelines, 9.55.

<sup>365</sup> See e.g. Rassolov – Aleksij – Kuzbagarov 2010, p. 336; Moskalev 2009, p. 249.

takes all the reasonable steps to keep the information confidential.<sup>366</sup> Thus, trade secrets/know-how must have *commercial value*, must be *secret* and must be known only to a restricted group of persons/companies (*exclusivity*). These criteria are consistent with Article 39 of the TRIPS Agreement, which sets out similar requirements for the protection of undisclosed information.<sup>367</sup>

As trade secrets/know-how are considered intellectual properties under Russian law, they will be subject to transfer pricing regulations also in business restructurings, if the transfers of know-how/trade secrets can be distinguished from other asset transfers and can be therefore identified as own separate items. In addition, such transfers must have value, which would be compensated in transactions between independent parties under similar conditions. The latter requirement is fulfilled in practice, when know-how/trade secret meets the above-mentioned requirements set by Russian law. In other words, know-how must have commercial value or otherwise it cannot be regarded as know-how. Furthermore, trade secrets/know-how can be transferred and licensed in accordance with specific provisions of the Civil Code,<sup>368</sup> which also indicates that they generally have commercial value.

The question concerning the requirement of distinguishing transfers of know-how and trade secrets from transfers of other assets in a business restructuring is far more complex. As it was mentioned above, they cannot be registered in a similar way as trademarks or patents, which would be helpful in identifying them in transactions and separating transfers thereof from other transfers possibly occurring in the business restructuring. In addition, a transfer of know-how/trade secrets is usually connected with transfers of tangible or intangible assets. Know-how is not very often transferred alone, but more likely along with other intangible assets in a package of agreements or with the personnel.<sup>369</sup> For instance, information that is considered know-how may be closely linked to patents that are transferred during a business restructuring between group companies.

Nevertheless, it is not necessarily impossible to distinguish the transfers of know-how/trade secrets from other potential asset transfers in a business restructuring. As discussed, the Civil Code contains particular provisions in

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<sup>366</sup> Article 1465 of the Civil Code. The holder must maintain a regime for the purposes of keeping the information confidential. More regulations with regard to trade secrets and regimes can be found in the specific act regulating trade secrets, see Federal'nyj zakon "O kommercheskoj tajne" ot 29.07.2004 N 98-FZ (Federal Act of the Russian Federation on Trade Secrets).

<sup>367</sup> See Niskakangas 1983, p. 13, where the criteria for the protection pursuant to the TRIPS Agreement are discussed in more detail.

<sup>368</sup> Articles 1469 and 1469 of the Civil Code.

<sup>369</sup> See e.g. Mehtonen 2005, pp. 222, 288; Haarmann 2001, p. 140.

relation to concluding agreements as to transferring the exclusive rights of trade secrets/know-how or licensing them.<sup>370</sup> These kinds of agreements could also be used in business restructurings in order to identify the transfers of know-how and trade secrets, and to separate them from other asset transfers occurring in restructurings. Also in the Russian legal literature, it has been considered possible to distinguish know-how from other intangible assets and to determine an individual transfer price alone for know-how.<sup>371</sup> The importance of performing a functional analysis diligently as part of the transfer pricing documentation cannot be thus highlighted in excess, if know-how is planned to be transferred in the restructuring. It will help companies to identify and separate transfers of know-how/trade secrets from other possible asset transfers occurring in the business restructuring.

On the basis of the aforesaid, if a business restructuring involves transfers of know-how/trade secrets, it seems that such transfers fall within the scope of the Russian transfer pricing rules. This is mainly due to the fact that know-how/trade secrets are intellectual properties pursuant to the existing law. As the prevailing transfer pricing provisions should be applied to controlled transfers of intellectual properties, that covers also know-how and trade secrets. This conclusion is also acceptable from the perspective of the arm's length principle. If independent parties would transfer or license know-how, it is very likely that such transactions would be remunerated, taking into account that trade secrets/know-how contain in the above-mentioned sense commercially valuable information. The arm's length principle is hence followed in this regard. However, as already discussed in the previous chapter, the existing transfer pricing rules can still be criticized in one respect. The interpretation of this specific question is greatly based on the FTS's and the Minfin's guidance, which is not legally binding in nature. The prevailing interpretation should be thus ultimately regulated in the Tax Code's transfer pricing provisions to eliminate any possible uncertainties on the matter and to achieve more authoritative legal support for the current interpretation.

In Finland, the terms "know-how" and "trade secrets" are, likewise, often used side by side and regarded to cover each other at least to some extent, although the terms are also considered ambiguous.<sup>372</sup> Know-how can be broadly understood as all the information and experience required for performing certain business activities, and such information and experience is valuable for

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<sup>370</sup> See Articles 1468–1469 of the Civil Code. It should be noted that if an agreement with regard to transferring exclusive rights of certain know-how/trade secrets do not contain an explicit mention of 'exclusive rights', know-how/trade secrets are deemed to be transferred under such agreement without exclusivity; see Borisov 2014, p. 1062.

<sup>371</sup> Shherbakov – Shherbakova 2006, p. 200.

<sup>372</sup> Haarmann 2001, p. 156; Haarmann 2014, pp. 456–457.

a company.<sup>373</sup> When the information, which is regarded as know-how, is in nature confidential, such information may also be considered a trade secret.<sup>374</sup> However, it has been stated in the legal literature that know-how can sometimes also be non-confidential in nature, such as general profession skills and expertise, in which case the know-how in question cannot be regarded at the same time as trade secret.<sup>375</sup> Under a broad definition of intellectual property rights, regulations regarding unfair competition, including the protection of trade secrets, are deemed to be part of intellectual property rights under Finnish law.<sup>376</sup>

The only act in Finland regulating trade secrets and know-how at least to some degree is the Finnish Unfair Business Practices Act (*Laki sopimattomasta menettelystä elinkeinotoiminnassa, 1061/78*). Pursuant to § 4 of the Finnish Unfair Business Practices Act, trade secrets are protected in four different situations: Trade secrets are first protected against business espionage. In addition, persons in the service of an entrepreneur may not unjustifiably use trade secrets. Similarly, persons acting on behalf of an entrepreneur cannot unjustifiably use or reveal such information. Lastly, persons who have received trade secrets from other persons, knowing that such information has been unjustifiably obtained or revealed, cannot use the trade secrets.<sup>377</sup>

Although the above-mentioned legislated provisions are not broad, trade secrets and know-how achieve legal protection through these provisions. Furthermore, as Finland is a signatory state to the TRIPS Agreement, the earlier discussed criteria for the protection of undisclosed information pursuant to Article 39 (commercial value, secret and exclusivity) are applicable also to know-how and trade secrets in Finland. As trade secrets and know-how are in the aforementioned manner recognized and protected under Finnish law, the next question is whether they may fall within the scope of application of the Finnish transfer pricing provisions, when they are transferred separately in business restructurings?

As it was discussed earlier, the preliminary works for the AAP specifically mention that transactions involving transfers of intangible assets fall within the scope of transfer pricing rules.<sup>378</sup> Trade secrets and know-how, being treated as intangibles and — under a broad definition of intellectual property rights — as intellectual properties under Finnish law, should be in the scope of

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<sup>373</sup> HE 114/1978, p. 14.

<sup>374</sup> Vapaavuori 2016, p. 73.

<sup>375</sup> Nyblin 2007, p. 237; Vapaavuori 2016, p. 73.

<sup>376</sup> Vapaavuori 2016, p. 30.

<sup>377</sup> See in more detail in Haarmann 2014, pp. 457–458.

<sup>378</sup> See HE 107/2006 vp, p. 20.

§ 31 of the AAP solely for the reason that intangible assets in general fall within the scope of application of the Finnish transfer pricing provisions. Furthermore, the preliminary works mention knowledge as one example of intangible property subject to transfer pricing,<sup>379</sup> which also supports this view. In addition, the Finnish Tax Administration's memorandum states that term "intangible property" must be understood broadly, as intangible property can generate income in transactions even if it cannot be registered or it is not transferable. The Tax Administration also explicitly mentions knowledge as one form of intangible property.<sup>380</sup>

The approach taken by the Finnish legal sources above is in line with the provisions of the OECD Transfer Pricing Guidelines. The term "intangible" has been left intentionally open in the guidelines in the earlier discussed manner: it refers in general to something, which is not a physical or a financial asset, which is capable of being owned/controlled, and the use or transfer of which would be compensated in transactions between independent parties.<sup>381</sup> The OECD Transfer Pricing Guidelines have specifically mentioned know-how and trade secrets as one form of intangible property. The concept of know-how and trade secrets under the guidelines is comparable to the definition under Finnish law. According to the guidelines,

"know-how and trade secrets are proprietary information or knowledge that assist or improve a commercial activity, but that are not registered for protection in the manner of a patent or trademark. Know-how and trade secrets generally consist of undisclosed information of an industrial, commercial or scientific nature arising from previous experience, which has practical application in the operation of an enterprise. Know-how and trade secrets may relate to manufacturing, marketing, research and development, or any other commercial activity.---"<sup>382</sup>

Most importantly, it must be noted that Chapter IX of the OECD Transfer Pricing Guidelines explicitly mentions know-how and trade secrets as intangible asset types, which should be taken into account in transfer pricing of business restructurings.<sup>383</sup> As there is no contradiction between the OECD Transfer Pricing Guidelines and Finnish law in terms of the concept of intangibles and know-how/trade secrets, the OECD approach should be taken

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<sup>379</sup> HE 107/2006 vp, p. 16. Alternatively, the Finnish word, 'osaaminen', may also be translated directly into 'know-how'.

<sup>380</sup> Finnish Tax Administration Memorandum 1471/37/2007, p. 24.

<sup>381</sup> OECD Transfer Pricing Guidelines, 6.6.

<sup>382</sup> OECD Transfer Pricing Guidelines, 6.20.

<sup>383</sup> OECD Transfer Pricing Guidelines, 9.55.



as the starting point also in Finland. This results from the fact that the OECD Transfer Pricing Guidelines, including Chapter IX, have been confirmed as a guiding source, when the arm's length principle and § 31 of the AAP are interpreted and applied in practice.<sup>384</sup>

Therefore, on the basis of the above said, transfers of know-how and trade secrets fall generally within the scope of the Finnish transfer pricing provisions. In business restructurings, they may become objects of transfer pricing as separate items, if they can also be identified and separated from other possible asset transfers occurring in the course of a business restructuring and if such transfers would be compensated in transactions between independent parties under comparable circumstances. It was earlier mentioned that such transfers usually generate profit due to the fact that the information/experience, which is protected as trade secret, has commercial value, or otherwise it cannot be regarded as trade secret. Even that kind of know-how, which cannot be regarded as trade secret under Finnish law, because the information in question is non-confidential in nature, usually has commercial value.<sup>385</sup> In addition, regardless of that know-how and trade secrets cannot be easily identified or separated from other assets, it is not impossible under Finnish law. As was the case in Russia, also in Finland the trade secrets and know-how, including know-how based on non-confidential information, can be transferred or licensed under the so-called "know-how licenses". In such situations, the importance of contractual terms becomes emphasized.<sup>386</sup> By defining the trade secrets/know-how thoroughly in such licensing or transfer agreements, they can be separated from other possible asset transfers occurring in the business restructuring context.

Hence, it is justified to state that transfers of trade secrets and know-how fall within the scope of application of the Finnish transfer pricing rules in business restructurings also as separate items. Such transfers must be conducted in a diligent way, and special attention must be paid to the contractual terms defining the information and knowledge to be transferred. Finnish law does not thus deviate from Russian law in terms of this particular question. Consequently, both countries follow the arm's length principle also in this situation. On the other hand, contrary to the existing situation in Russia, the Finnish legal sources (and the OECD Transfer Pricing Guidelines that are followed in this respect) regulate the question in a manner that makes conflicting interpretations of the matter impossible. As the corresponding Russian sources are more clarifying in nature (not legally binding), it is more problematic that the interpretation of the question lacks support from more

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<sup>384</sup> Finnish Tax Administration: Statement A177/200/2015; KHO 2013:36.

<sup>385</sup> Vapaavuori 2016, p. 73.

<sup>386</sup> Haarmann 2014, p. 458; Vapaavuori 2016, pp. 73 and 353.

authoritative legal sources, i.e. the Tax Code's provisions. In this respect, there is thus a need for amendments in Russia.

In the USA, know-how and trade secrets have been traditionally regarded as "a set of secret techniques and information, including those of a commercial nature, used in an enterprise."<sup>387</sup> As being a signatory state to the TRIPS Agreement, trade secrets and know-how must be protected under U.S. law in a similar way as they are protected in Russia and Finland. In general, they have been conventionally protected under the laws of states. On the other hand, the Restatement of Unfair Competition has also been of practical importance, as the Supreme Court of the USA has cited its definition of trade secrets in the decisions.<sup>388</sup> Trade secret has been defined in the Restatement of Unfair Competition as follows: "A trade secret is any information that can be used in the operation of a business or other enterprise and that is sufficiently valuable and secret to afford an actual or potential economic advantage over others."<sup>389</sup>

Nowadays, the majority of the states have adopted the Uniform Trade Secrets Act,<sup>390</sup> which also contains a definition of trade secret: "Trade secret means information, including a formula, pattern, compilation, program, device, method, technique, or process, that: (i) derives independent economic value, actual or potential, from not being generally known to, and not being readily ascertainable by proper means by, other persons who can obtain economic value from its disclosure or use, and (ii) is the subject of efforts that are reasonable under the circumstances to maintain its secrecy."<sup>391</sup> Pursuant to these legislative acts, trade secrets and know-how (when it falls under the definition of trade secret) achieve legal protection under U.S. law, if they concern information, which is secret, exclusive and has independent commercial value.<sup>392</sup> That being said, the concept of protectable trade secret/know-how is clearly understood in U.S. law similarly as in Russian and Finnish law.

As know-how and trade secrets are recognized and protected under U.S. law in the above-discussed manner, whether they may fall within the scope of application of the U.S. transfer pricing rules as separate items must be examined. As with the question of transfer pricing of intellectual property

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<sup>387</sup> Correa 1981, p. 458.

<sup>388</sup> ABA 2006, p. 186.

<sup>389</sup> See Section 39 of the Restatement (third) of Unfair Competition.

<sup>390</sup> See e.g. Thomas 2010, p. 7.

<sup>391</sup> Section 1 of the Uniform Trade Secrets Act.

<sup>392</sup> See also the Economic Espionage Act, which criminalizes the theft of trade secrets as well as the so-called economic espionage. In addition, more protection against trade secret theft was introduced in 2016 in the new Defend Trade Secrets Act.

rights, U.S. law is more straightforward, when it comes to transfer pricing of know-how and trade secrets. It was mentioned earlier that the concept of intangible property for transfer pricing purposes is regulated in Section 936(h)(3)(B) of the IRC, as well as in the respective Treasury Regulations. Pursuant to these provisions, the term “intangible property” also explicitly covers know-how for the purposes of Section 482 of the IRC, if it has substantial value independent of the services of any individual. In addition to the mention of know-how, the section specifically mentions formulas, patterns and processes as intangible properties subject to Section 482 of the IRC.<sup>393</sup> It must be noted that these information types also fall within the definition of trade secret pursuant to the Uniform Trade Secrets Act. Thus, solely from this point of view, it is clear that transfers of know-how and trade secrets are in the scope of application of the U.S. transfer pricing rules.

It must also be observed that the aforesaid exception rule, under which certain transfers of assets by a U.S. company to a foreign company may be free of taxes,<sup>394</sup> is not applicable to transfers of know-how and trade secrets. It was discussed above that this exception cannot be applied to transfers of intangible property (with the meaning of Section 936(h)(3)(B) of the IRC). As know-how and trade secrets are regarded as intangible properties pursuant to Section 936(h)(3)(B), they are excluded from the scope of application of the exception rule.<sup>395</sup> Consequently, transfers of know-how and trade secrets from a U.S. company to a foreign company are generally taxable transactions,<sup>396</sup> meaning that they are also subject to the arm’s length principle in controlled transactions. This ultimately supports the view according to which transfers of know-how and trade secrets should fall within the scope of transfer pricing rules also in cross-border business restructurings.

Moreover, other requirements of becoming an object of transfer pricing in business restructurings as a separate item are also met in U.S. law. The definition of trade secrets and know-how requires that such assets have independent economic value in the above-discussed manner. This has also been confirmed in the case law<sup>397</sup> and the legal literature<sup>398</sup>, where it has been stated that transfers of such property usually constitute profit, which is subject

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<sup>393</sup> See Treas. Reg. § 1.482-4(b).

<sup>394</sup> If such assets will be used in the active conduct of a trade or business outside of the USA; see Section 367(a)(1) and Section 367(a)(3)(A) of the IRC.

<sup>395</sup> Section 367(d) of the IRC.

<sup>396</sup> Darby 2006, p. 40.

<sup>397</sup> See e.g. *Shepard v. Commissioner*, 57 T.C. 600, 617-618 (1972), 481 F.2d 1399 (3d Cir. 1973), 417 U.S. 911 (1974), 1975-1 C.B. 3., where know-how was regarded as intangible property, which has separate value and is subject to income taxation.

<sup>398</sup> Darby 2006, p. 40.

to taxation. Trade secrets and know-how have hence this kind of commercial value, which would be compensated in transactions between independent parties.

Furthermore, the wording used in the Treasury Regulations implies that know-how as well as formulas, patterns and processes have the ability to be separated from other assets. They are listed as own separate asset types to be regarded as intangible assets; in addition, they are considered specifically intangible properties subject to transfer pricing, when they have “substantial value independent of the services of any individual.”<sup>399</sup> More importantly, it has been confirmed in U.S. court decisions that trade secrets/know-how can be transferred alone.<sup>400</sup> In addition, in the legal literature it has been viewed that trade secrets can be transferred and licensed quite freely as separate items. As was the case in Russia and Finland, know-how and trade secret can also be licensed or transferred alone in the USA through licensing and transfer agreements,<sup>401</sup> which indicates that they can also be separated, by using such agreements, from other transfers occurring in the business restructuring context.

On the basis of the above mentioned, it is justified to state that the transfers of trade secrets/know-how will fall within the scope of the U.S. transfer pricing rules separately, when a going concern is not transferred in a business restructuring. Taking into consideration that the concept of know-how/trade secret has been defined to a great extent similarly in Russia, Finland and the USA, and that their transfers fall within the scope of the national transfer pricing rules in business restructurings in a similar manner, Russian, Finnish and U.S. law are in line with each other in this respect.

In the existing legal situation, the arm’s length principle is thus generally followed in Russia, Finland and the USA, when cross-border business restructurings involve transfers of know-how and trade secrets. As such transfers fall within the scope of the national transfer pricing regulations, they must be compensated at arm’s length, if unrelated parties would in comparable situations also compensate such transfers. Nonetheless, as was the case with transfers of intellectual properties in general, more reliable arm’s length results may be achieved currently in Finland and the USA, when compared to Russia. The former countries recognize the possibility that transfers of know-how/trade secrets are included in the transfer of a going concern, when a functioning business unit is transferred in the restructuring. As discussed, this may in certain circumstances result in a more reliable arm’s

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<sup>399</sup> Treas. Reg. § 1.482-4(b); Section 936(h)(3)(B) of the IRC.

<sup>400</sup> See *Shepard v. Commissioner* above.

<sup>401</sup> See e.g. Albert 2010, p. 95; DeGeeter 2004, p. 102; Olson 2005, § 8.04 – § 8.08; Cohen 1998, p. 127.

length result than what would be achieved by valuing contemporaneous transfers of interrelated assets separately. As the simultaneous transfers of assets should always be analyzed and valued on a transaction-by-transaction basis at present in Russia, amendments to the legislation are needed.

Another difference between Russian law and the laws of Finland and the USA is that this particular question (i.e. whether know-how/trade secrets may become objects of transfer pricing) is more interpretive question in Russia than in Finland and the USA. As with the transfers of intellectual properties, it is self-evident from the aforementioned Finnish and U.S. legal sources that transfers of know-how/trade secrets should be objects of transfer pricing. In Russia, legally authoritative sources have not dealt with the question at all, and therefore the aforesaid question is widely interpreted with references to legal sources having only clarifying non-binding nature (i.e. the Minfin's and the FTS's guidance). Therefore, the prevailing interpretation should preferably be regulated in the Tax Code's transfer pricing provisions to achieve more authoritative legal support for the current interpretation. There are no such needs for improvements to the legislation *de lege ferenda* in Finland and the USA.

### **3.6.5 GOODWILL AND GOING CONCERN VALUE**

A group company may also transfer a part of its goodwill to an associated company located in another jurisdiction during the process of a cross-border business restructuring.<sup>402</sup> Goodwill can be defined as a brand value, which is based on the customers' positive feelings and experiences in relation to the company's products and services. It arises from the company's products, services and everyday business activities, such as marketing activities. Goodwill is closely linked to the company's trade name or trademarks, because they usually evoke the said positive feelings in customers.<sup>403</sup>

Going concern was defined earlier as a "functioning organizational unit." The concept of going concern must be separated from the concept of *going concern value*. In contrast to going concern, going concern value means an increased value of a company's or its business unit's assets, which results from using these company's assets together in business activities. The aggregate value of the assets is in reality higher than if the net values of the assets would be totaled up. Going concern value is created by a company's possibility to minimize its costs by using the assets in its possession efficiently in its entrepreneurial activities in comparison to a newly established company,

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<sup>402</sup> Van Herksen – Levey – Fletcher 2008, p. 4.

<sup>403</sup> Henshall 2008, p. 54.

which must take care of costs resulting from starting a business. These kinds of assets producing going concern value may be, inter alia, results of R & D, existing client and credit agreements as well as experienced personnel. Going concern value is traditionally considered an intangible asset.<sup>404</sup> Also, a company's going concern value may be transferred in the business restructuring context.

In this section, it is examined in particular whether transfers of goodwill and/or going concern value may be objects of the national transfer pricing provisions of Russia, Finland and the USA separately from other possible asset transfers in the course of business restructurings. Before reviewing the question from the perspective of national laws, it must be highlighted that the transfer pricing of goodwill and going concern value is an uneasy question in general. Even the OECD Transfer Pricing Guidelines did not, for a long time, mention goodwill and going concern value as intangible assets in Chapter VI of the guidelines, although the chapter deals with the transfer pricing aspects of intangibles in detail. Until the autumn of 2014, there had not been international standards in relation to the transfer pricing of transfers of goodwill and going concern value.<sup>405</sup>

According to the newest provisions of Chapter VI of the OECD Transfer Pricing Guidelines, goodwill and going concern value<sup>406</sup> can be defined in many different ways. The guidelines do not attempt to give them a precise definition; in addition, they do not specify when goodwill and going concern value can be regarded as intangibles. According to the guidelines, it does not even matter, whether the transferred value in a related party transaction is defined as goodwill or going concern value:

“If features of a business such as a reputation for producing high quality products or providing high quality service allow that business to charge higher prices for goods or services than an entity lacking such reputation, and such features might be characterised as goodwill or ongoing concern value under one or another definition of such terms, such features should be taken into account in establishing arm's length

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<sup>404</sup> Wiener 1979, p. 183; Oswald 1991, p. 289.

<sup>405</sup> The OECD renewed its guidelines in respect of intangibles in its entirety as a result of the BEPS Project. See more about the project in OECD Action Plan on BEPS and OECD Guidance on Transfer Pricing Aspects of Intangibles. The new provisions with regard to the transfer pricing of intangibles were introduced in their final form in the OECD BEPS Actions 8–10 in 2015. These new provisions amended the former provisions as they were insufficient in respect of providing guidance in relation to transfers of intangibles, including goodwill and going concern value.

<sup>406</sup> The guidelines use term “ongoing concern value.”

prices for sales of goods or the provision of services between associated enterprises whether or not they are characterised as goodwill.”<sup>407</sup>

The OECD’s approach starts with the premise that, if independent parties would compensate value which might be characterized as goodwill or going concern value in their transactions, the related parties should compensate this value accordingly in their transactions as well.<sup>408</sup>

Does Russia’s approach to transfer pricing of goodwill and going concern value differ from the OECD’s approach then? First, the definition of goodwill (in Russian *delovaya reputatsiya (yuridicheskogo lica)* or *gudvil*) is understood in Russia similar to the above mentioned. Goodwill is regarded as the value, which a company has and which stems from (positive) reputation and experiences of the company and its products and services.<sup>409</sup> Although goodwill is not specifically regulated in the Russian legislation, it is recognized as an intangible asset by Russian case law and literature<sup>410</sup> — and even by the Minfin.<sup>411</sup>

On the contrary, going concern value has not been discussed in the Russian legal literature and case law, not to mention legislation. It appears that going concern value is often considered as part of goodwill or even as the same (legal) phenomenon. For instance, a company’s clientele, existing agreements and experienced staff are regarded as assets, which create the company’s goodwill.<sup>412</sup> These kinds of assets were mentioned above as assets creating a company’s going concern value, not goodwill. It seems that Russian legal literature — as well as Russian law in general — does not recognize going concern value as a separate intangible asset, and therefore it cannot be examined further regarding whether it could fall within the scope of transfer pricing regulations in Russia as a separate asset. Nonetheless, going concern

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<sup>407</sup> OECD Transfer Pricing Guidelines, 6.28.

<sup>408</sup> OECD Transfer Pricing Guidelines, 6.27–6.29.

<sup>409</sup> See e.g. Esipov – Makhovikova 2016, p. 211, Shherbakov – Shherbakova 2006, pp. 198–199; Sukhanov 2006, pp. 392–393; Ershova 2007 pp. 204–205.

<sup>410</sup> See Esipov – Makhovikova 2016, p. 211 and Kozyrev – Makarov 2003, pp. 24–25. It must be observed that the Civil Code has regulations about the protection of commercial reputation, but these regulations concern only the reputation of physical persons (see e.g. Articles 150, 152 of the Civil Code). See also Shherbakova 2008, p. 1.

<sup>411</sup> See the Minfin’s order on confirming the accounting standard PBU 14/2007 with regard to intangible assets Prikaz Minfina Rossii ot 27.12.2007 N 153n (red. ot 16.05.2016) "Ob utverzhdenii Polozheniya po bukhgalterskomu uchetu "Uchet nematerial'nykh aktivov" (PBU 14/2007)" (Zaregistrovano v Minyuste Rossii 23.01.2008 N 10975) and the PBU 14/2007 itself.

<sup>412</sup> Shherbakova 2008, p. 1.

value can be deemed to be included in the concept of goodwill in the aforementioned manner.

Now, in order to review whether at least transfers of goodwill could be objects of transfer pricing in business restructurings, they should be distinguishable from other assets transferred in a transaction, have commercial value which would be compensated in transactions between independent parties and be regarded as an asset type subject to transfer pricing pursuant to the Russian transfer pricing regulations. As the Tax Code fails to mention transfer pricing rules' possible applicability to transfers of goodwill — and overall lacks mentions of goodwill — the last requirement means that goodwill must be considered as intellectual property under Russian law, or otherwise it cannot fall within the scope of the transfer pricing regulations at all.

The first two requirements already cause difficulties, however. It is generally viewed in the legal literature that a company's goodwill cannot be transferred separately. The transfer of goodwill usually requires that the whole business unit is transferred simultaneously. Even then, it is very likely that it cannot be identified and distinguished from the other transferred assets.<sup>413</sup> This view is also shared in the Russian literature and supported by IFRS 3, which is also applied in Russia.<sup>414</sup>

In addition, it has been considered that goodwill value, which arises inside a company from its profitable business activities in the course of time (*internally generated goodwill*), cannot be recorded as an intangible asset as such on the company's balance sheet, and therefore it cannot be distinguished from other assets. In many countries, including Russia, recordable goodwill could arise only in business acquisitions.<sup>415</sup> Goodwill value would then be the difference between the purchase price of the company and the net book value of the company's assets and liabilities. According to the Minfin's order and accounting standard PBU 14/2007, the goodwill may in that case be recorded

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<sup>413</sup> Cordova – Mitra – Newman – Reams – Shanda – Shapiro 2012, p. 47.

<sup>414</sup> See Kozyrev – Makarov 2003, p. 26; Pushkin – Grishin 2011, p. 236. Russia applies in practice the International Financial Reporting Standard (IFRS) 3, which deals with business combinations, see the Minfin's regulation *Prikaz Ministerstva finansov Rossijskoj Federatsii ot 25.11.2011 N 160n "O vvedenii v dejstvie Mezhdunarodnykh standartov finansovoj otchetnosti i Raz'yasnenij Mezhdunarodnykh standartov finansovoj otchetnosti na territorii RF."* IFRS 3 defines goodwill as benefits arising from other assets that are not capable of being individually identified and separately recorded; see IFRS 3, Appendix A.

<sup>415</sup> Sugaipova – Yurkhanyan 2011, p. 2; Dontsov – Anichkin – Syrbe 2009, p. 30.



on the balance sheet only if the acquisition concerns a purchase of a complex of assets (a whole company or a part of it).<sup>416</sup>

It seems that Russian law sets very strict requirements for when goodwill could be regarded as an intangible asset on the balance sheet of a company. It can be recorded on the balance sheet only after a purchase of a company (or a part of it), which also means that only then it can be distinguished from other intangible and tangible assets to some extent, and only purely for accounting purposes. The problem is that internally generated goodwill may never be recorded in this way — and thus be identified. More importantly, goodwill cannot be transferred and valued separately in transactions according to current Russian law and legal literature. In business restructurings, the above mentioned means that there are strong grounds for concluding that a possible transfer of goodwill (as well as going concern value) in the course of a business restructuring cannot be distinguished from other asset transfers, and therefore it cannot also fall within the scope of application of the Russian transfer pricing regulations in this context as a separate asset.

This interpretation is also supported by the fact that, ultimately, goodwill cannot be regarded as intellectual property under Russian law. Article 1225 of the Civil Code does not mention it as one of the intellectual properties protected by Russian law. Also, according to the Russian legal literature, goodwill is generally considered to be an intangible asset, but not specifically an intellectual property safeguarded by the Russian legislation.<sup>417</sup> Due to the fact that goodwill cannot be not regarded as intellectual property under Russian law, it does not fulfill the requirement set by the previously discussed Minfin's written clarifications and the FTS's letter, and therefore it cannot fall within the scope of application of the Tax Code's transfer pricing rules and be subject to transfer pricing. Finally, also tax practitioners have found it impossible that the current Russian transfer pricing rules could be applied to transactions concerning transfers of goodwill and/or going concern value, and hence they have not applied the rules to such transfers either.<sup>418</sup> Consequently, when cross-border business restructurings involve transfers of goodwill and/or going concern value together with other asset transfers, they very likely fall outside the scope of application of the Tax Code's transfer pricing provisions, and are not objects of transfer pricing.

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<sup>416</sup> Prikaz Minfina Rossii ot 27.12.2007 N 153n (red. ot 16.05.2016) "Ob utverzhdenii Polozheniya po bukhgalterskomu uchetu "Uchet nematerial'nykh aktivov" (PBU 14/2007)" (Zaregistrovano v Minyuste Rossii 23.01.2008 N 10975) and PBU 14/2007, Section VIII.

<sup>417</sup> Azgaldov – Karpova 2006, p. 86.

<sup>418</sup> Expert Interview 2012.

The existing legal situation in Russia can be heavily criticized from the perspective of the arm's length principle. Although goodwill (as well as going concern value) cannot be transferred separately from other assets in transactions conducted between independent parties, it is clear that such value would nevertheless be compensated when a complex of assets or a business unit is transferred between unrelated parties. In such situations, independent parties would likely compensate such transactions on an aggregate basis, which would also cover the transfer of goodwill. As the arm's length principle requires that transactions conducted between related parties should ultimately conform to transactions conducted between unrelated parties in comparable circumstances in terms of commercial conditions, related parties should also compensate transfers of goodwill at least so that its value should be included in the aggregate compensation amount of a going concern/complex of assets.

As discussed, the current Russian transfer pricing regulations and the interpretation thereof does not allow such a conclusion that business restructurings could be regarded as transfers of a going concern, even when a functioning business unit is transferred. Consequently, related parties should review and compensate all transfers of assets that have occurred in the restructuring on a transaction-by-transaction basis, if they fall within the scope of the transfer pricing rules. This means that transfers of goodwill will fall outside the scope of the transfer pricing rules entirely, and therefore they do not have to be taken into account in the arm's length analysis of related party transactions involving transfers of them in the business restructuring context. The sum of separate compensations paid in a business restructuring for transfers of assets/something of value by related parties may thus deviate remarkably from the aggregate valuation of such assets/something of value applied by independent parties, as the latter approach may also take into consideration the value of goodwill. In this sense, the purpose of the arm's length principle, which should be the guiding principle behind the national transfer pricing provisions in Russia, is not necessarily completely realized in this particular transfer pricing question. Hence, the Tax Code's transfer pricing rules should be amended *de lege ferenda* to better meet the aims of the arm's length principle in this regard.

In Finland, the concept of goodwill is similarly understood. Goodwill is a value stemming from (positive) reputation and brand recognition of a company,<sup>419</sup> and, despite the fact that it has not been specifically defined in the legislation, it has been protected in the case law.<sup>420</sup> In accounting, goodwill is defined as

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<sup>419</sup> Haarmann – Mansala 2012, p. 174.

<sup>420</sup> See e.g. decisions MAO 121/2012 and MAO 381/2012 of the Finnish Market Court. The basis for the legal protection is regulated in § 1 of the Finnish Unfair Business Practices Act, according to which in

the difference between the yield value and the net asset value, which arises from the fact that the value of a company as a whole is greater than the sum of the book values of the individual production factors.<sup>421</sup> The concept of going concern value, on the other hand, has not been discussed in the Finnish legal literature. Usually the factors, which create going concern value for the company in the above-discussed manner, such as customer relationships, existing agreements and the place of business, are considered to be the basis for the creation of goodwill.<sup>422</sup> It seems that, as was the case in Russia, the concept of going concern value is not separated from the concept of goodwill as independent intangible asset type under Finnish law, but is more likely included in the latter concept.

The OECD Transfer Pricing Guidelines define the concepts of goodwill and going concern value in the aforementioned manner broadly. According to the guidelines, it does not even matter whether, or not, certain factors are characterized as goodwill or going concern value. These kinds of factors, such as a reputation for manufacturing high quality products, must be taken into account in determining the arm's length compensation despite the characterization, if such factors would affect the remuneration paid in transactions between independent parties.<sup>423</sup> As Finnish tax law does not provide definitions of goodwill and going concern value for transfer pricing purposes, the OECD's definitions and the aforesaid approach must primarily be followed also in Finland.

The Finnish transfer pricing regulations contain no specific mention of goodwill or going concern value either, nor potential applicability of § 31 of the AAP to transactions involving transfers of them. Pursuant to the preliminary works<sup>424</sup> and the Tax Administration's memorandum,<sup>425</sup> intangible assets fall in general within the scope of application of the Finnish transfer pricing provisions. Furthermore, the Tax Administration's memorandum mentions that term "intangible property" must be understood broadly for transfer pricing purposes, and it does not matter whether the intangible property is

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business activities, no practices contrary to good business practice or which could otherwise be unfair to other entrepreneurs can be used.

<sup>421</sup> Bergström 2002, p. 463; Kaisanlahti – Jänkälä – Björklund 2009, p. 198.

<sup>422</sup> Mähönen – Villa 2015, p. 256; Kaisanlahti – Jänkälä – Björklund 2009, p. 199. It must be noted that in the legal literature the principle of going concern has been recognized as an accounting principle, which refers to the continuity of business activities of a company in future. See about this in Kaisanlahti – Jänkälä – Björklund 2009, pp. 93–94.

<sup>423</sup> OECD Transfer Pricing Guidelines, 6.28.

<sup>424</sup> HE 107/2006 vp, p. 20.

<sup>425</sup> Finnish Tax Administration Memorandum 1471/37/2007, p. 24.

registered or transferable.<sup>426</sup> Taking the above into account, and the fact that the OECD Transfer Pricing Guidelines mention goodwill and going concern value as intangible asset types subject to transfer pricing,<sup>427</sup> transactions involving transfers of goodwill/going concern value should primarily fall within the scope of application of the Finnish transfer pricing provisions too, if they would be remunerated in transactions performed between unrelated parties.

On the other hand, the question of whether transfer of goodwill and/or going concern value can be subject to transfer pricing separately in the business restructuring context is more troublesome. As mentioned above, goodwill generally lacks the ability to be transferred alone.<sup>428</sup> This is also the case in Finland. Basically, only goodwill arising from corporate acquisition and mergers can be recorded as goodwill on the company's balance sheet.<sup>429</sup> The difference between the yield value and the net asset value is in this case recorded as goodwill.<sup>430</sup> In this way, goodwill value can, to some extent, be separated solely for accounting purposes. Conversely, it has been stated that internally generated goodwill can be never recorded, even for accounting purposes, as an intangible asset on the company's balance sheet,<sup>431</sup> and therefore it cannot then be distinguished from other assets.

Although goodwill can under some circumstances be recorded on the balance sheet of a company, it still lacks the ability to be transferred separately from other assets. Goodwill is always closely linked to the valuation of a whole company/business unit. This means that goodwill cannot actually be assigned and valued separately in transactions, where a functioning business is not transferred at the same time. This view has also been shared in the Finnish legal literature. It has been stated that, in light of the OECD Transfer Pricing Guidelines, it does not seem to be possible or justified that, if a going concern (business unit) is not transferred in the course of a business restructuring, the goodwill could be taken into account in the valuation.<sup>432</sup>

The OECD Transfer Pricing Guidelines have also confirmed this observation in their newest provisions. According to the new provisions, it is "generally recognized" that goodwill and going concern values cannot be transferred separately but only together with other assets belonging to the company's

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<sup>426</sup> Ibid.

<sup>427</sup> OECD Transfer Pricing Guidelines, 6.18, 6.27–6.28.

<sup>428</sup> Finan – Launiau 2011, p. 3; Cordova et al. 2012, p. 47.

<sup>429</sup> Mähönen – Villa 2015, p. 256

<sup>430</sup> Bergström 2002, p. 463; Kaisanlahti – Jänkälä – Björklund 2009, p. 198.

<sup>431</sup> See e.g. Bergström 2002, p. 463; Leppiniemi – Kaisanlahti 2016, p. 183.

<sup>432</sup> Knuutinen 2015, p. 1067.

business. As such, the guidelines refer to the provisions of Chapter IX of the OECD Transfer Pricing Guidelines, which generally regulate transfer and valuation of a going concern in the business restructuring context.<sup>433</sup> This is a strong indication that possible transfers of goodwill and/or going concern value (whether included in the concept of goodwill or not, and whether characterized as goodwill/going concern value or not) in the course of a business restructurings may not be conducted at all separately from other asset transfers under Finnish law too, but only as part of a going concern, if such can be deemed to be transferred in the business restructuring.

Therefore, taking into consideration that the OECD Transfer Pricing Guidelines must be followed in practice in Finland and that Finnish law does not recognize a particular possibility of transferring goodwill/going concern value separately in the above-mentioned manner, it is clear that transactions involving transfers of goodwill/going concern value may not fall within the scope of application of the Finnish transfer pricing provisions as separate items in business restructurings. On the other hand, when a business restructuring involves a transfer of a going concern, goodwill/going concern value should be included in the going concern, and the arm's length compensation shall be determined on an aggregate basis in that case for the whole functioning business unit (going concern).<sup>434</sup> Ultimately, goodwill/going concern value is thus the object of transfer pricing as a part of the going concern. Consequently, a major difference is evident between Russian and Finnish law in this regard; as the Russian transfer pricing rules do not recognize the possibility of transferring a going concern, transfers of goodwill/going concern value are never subject to transfer pricing — which is troublesome from the perspective of the arm's length principle.

In contrast, the current legal situation in Finland is in line with the arm's length principle. Goodwill and going concern value lack the ability of being separated from other assets. Nevertheless, they clearly have commercial value that would be compensated in transactions between independent parties.<sup>435</sup> For instance, when a business is transferred in a business acquisition between independent parties, the value paid for the business may exceed the total value of the assets belonging to the business unit, and such value may even be recorded in the balance sheet as goodwill.<sup>436</sup> Therefore, as related parties must take into consideration possible transfers of goodwill/going concern value in a business restructuring, when a functioning business unit (going concern) is

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<sup>433</sup> OECD Transfer Pricing Guidelines, 6.27.

<sup>434</sup> See OECD Transfer Pricing Guidelines, 9.69.

<sup>435</sup> OECD Transfer Pricing Guidelines, 6.27–6.28.

<sup>436</sup> Mähönen – Villa 2015, p. 256; IFRS 3, 32; OECD Transfer Pricing Guidelines, 9.68–9.69.

transferred, related parties are put in the same position as unrelated parties in comparable circumstances.

In the USA, goodwill and going concern value are considered to represent the operational value of an on-going business; these intangible assets are the attributes that make the value of a business worth more than its individual parts altogether.<sup>437</sup> Traditionally, goodwill has been defined as “the value of a trade or business attributable to the expectancy of continued customer patronage. This expectancy may be due to the name or reputation of a trade or business or any other factor.”<sup>438</sup> As such, the concept of goodwill is understood in a similar way as in Russia and Finland, as well as under the OECD Transfer Pricing Guidelines.

In contrast to Russian and Finnish law, U.S. law has also specifically dealt with the concept of going concern value, and it cannot be therefore deemed to be included in the concept of goodwill under U.S. law. Going concern value has been defined as “the value attributable to the ability of a trade or business (or a part of a trade or business) to continue functioning or generating income without interruption notwithstanding a change in ownership.”<sup>439</sup> In case law, going concern value has been defined, *inter alia*, as an additional value, which “attaches to property by reason of its existence an integral part of a going concern.”<sup>440</sup> These definitions are in line with the general definition of going concern value above and with the OECD Transfer Pricing Guidelines.

As it was earlier discussed, the intangible property subject to transfer pricing under U.S. tax law is regulated in Section 936(h)(3)(B) of the IRC as well as in the corresponding Treasury Regulations under Section 482 of the IRC.<sup>441</sup> The lists do not specifically mention either goodwill or going concern value as intangible property falling within the scope of application of the U.S. transfer pricing regulations. Nonetheless, the lists are not exhaustive and refer to “other similar items”, which also are regarded as intangible property. For the purposes of Section 482 of the IRC, “an item is considered similar to those listed in paragraph (b)(1) through (5) of this section if it derives its value not from its physical attributes but from its intellectual content or other intangible properties.” In the legal literature, there have been discussions about whether goodwill and going concern value could be regarded as “other similar items,”

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<sup>437</sup> Darby 2006, pp. 40–41.

<sup>438</sup> Treas. Reg. § 1.1060-1(b)(2)(ii).

<sup>439</sup> *Ibid.*

<sup>440</sup> *VGS Corp. v. Commissioner*, 68 T.C. 563 (1977). See also e.g. *Winn-Dixie Montgomery, Inc. v. United States*, 444 F.2d 677 (5th Cir. 1971). See in general about the case law as to going concern value in King 2004, pp. 75–76.

<sup>441</sup> Treas. Reg. § 1.482-4(b).

but no consensus has been reached on the question.<sup>442</sup> The IRS has interpreted the issue in its transfer pricing audits so that it considers goodwill and going concern value as other similar items falling under the definition of intangible property subject to transfer pricing,<sup>443</sup> although the issue has remained ambiguous.

However, in *Veritas*<sup>444</sup>, which dealt with the valuation of intangibles for a buy-in-transaction of a cost sharing arrangement, the Tax Court finally took a stand on the question. Pursuant to the decision, the Tax Court was of the opinion that goodwill and going concern value may not be regarded as “other similar items” and therefore as intangible property for the purposes of Section 936(h)(3)(B) and correspondingly for transfer pricing purposes (for the purpose of Section 482 of the IRC). Although the IRS did not appeal against this decision, it did not nevertheless agree with the Tax Court and did not consequently change its interpretation of the issue, as it considered the decision erroneous.<sup>445</sup> Thus, the decision brought no long-awaited clarity to the question.

On the other hand, in this connection, the aforementioned exception rule in Section 367 of the IRC regarding tax-free transfers of assets (in connection with an exchange) by a U.S. company to a foreign company must also be taken into consideration. According to the rule, such transfers may be considered free of taxes if the assets will be used in the active conduct of a trade or a business of the foreign company outside the USA.<sup>446</sup> As it was discussed above, pursuant to Section 367(d) of the IRC, this exception cannot be applied to transfers of intangible property (with the meaning of Section 936(h)(3)(B) of the IRC). This means that outbound transfers of such intangibles are always subject to U.S. taxes and therefore also to transfer pricing. As the ambiguity with regard to goodwill and going concern value even after *Veritas* still remains (i.e. whether they could be regarded as Section 936(h)(3)(B) intangibles), it has been unclear for some time whether the exception rule could be applied to outbound transfers involving them. Respectively, it has also been thus ambiguous whether they could fall outside the scope of the transfer pricing rules at least in the event of the above-mentioned exchanges.

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<sup>442</sup> See more about the debate in Aksakal – Femia 2013, p. 3 (especially footnote 16).

<sup>443</sup> MacGregor 2014, p. 2.

<sup>444</sup> *Veritas Software Corporation v. Commissioner*, 133 T.C. 297 (2009).

<sup>445</sup> Silverman – Kidder – Gordon 2014, pp. 226–233; Aksakal – Femia 2013, p. 5; Hoffman – Zollo 2011, p. 85. See also the IRS’s Action On Decision (AOD 2010-05), where the IRS explains, why “the factual findings [of the Tax Court] and legal assertions are erroneous” and why the IRS therefore “does not acquiesce in the result or the reasoning of the decision.”

<sup>446</sup> Section 367(a)(1) and Section 367(a)(3)(A) of the IRC.

Nonetheless, it must be observed that the Treasury Regulations interpreting Section 367 contained previously, until 16 December 2016, particular provisions, according to which outbound transfers of *foreign goodwill* and *foreign going concern value*<sup>447</sup> could — in contrast to intangibles with the meaning of Section 936(h)(3)(B) of the IRC — qualify for the tax-free treatment.<sup>448</sup> Thus, the Treasury Regulations in this sense previously confirmed explicitly the applicability of the exception rule to outbound transfers of foreign goodwill and going concern value to the extent such transfers met the requirements for such a treatment. It was interpreted in the legal literature that this exception was correspondingly also applicable to outbound transfers of domestic goodwill and going concern value under the same circumstances.<sup>449</sup> In the transfer pricing context, this meant that at least outbound transfers of goodwill and going concern value, which met the requirements of the exception rule (active conduct of a trade or a business of the foreign company outside the USA), were not in the scope of application of the U.S. transfer pricing rules either. As this exception required that the assets were also transferred in connection with exchanges for shares in the event of liquidation, incorporation or reorganization, such tax-free transfers nonetheless ultimately fell outside the concept of business restructurings, at least to the extent discussed in this research.

The question with respect to outbound transfers of goodwill and going concern value (both domestic and foreign) and the general treatment thereof for tax and transfer pricing purposes has become somewhat clearer just recently. The U.S. Treasury Department, as well as the U.S. Administration, have in recent years focused on preventing possible base erosion resulting in particular from outbound transfers of intangibles, including transfers of foreign goodwill and going concern value. Especially the Treasury Regulations, which allowed the tax-free treatment for outbound transfers of (foreign) goodwill and going concern value, when transferred to active foreign businesses, were considered troublesome.<sup>450</sup> As a result of many years' preparatory work, the U.S. Treasury Department and the IRS published proposed regulations on 14 September 2015 and final regulations on 16 December 2016 to address their concerns. The

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<sup>447</sup> Foreign goodwill and going concern value was defined in the former § 1.367(a)-1T(d)(5)(iii) of the Treasury Regulations as follows: "Foreign goodwill or going concern value is the residual value of a business operation conducted outside of the United States after all other tangible and intangible assets have been identified and valued. For purposes of Section 367 and regulations thereunder the value of the right to use a corporate name in a foreign country shall be treated as foreign goodwill or going concern value."

<sup>448</sup> See abolished Treas. Reg. § 1.367(d)-1T(b).

<sup>449</sup> See e.g. Zollo 2011, pp. 759–762, 770; Yoder 2012, pp. 3–4; MacGregor 2014, p. 2; Aksakal – Femia 2013, pp. 2–5.

<sup>450</sup> Asali – Femia 2016, pp. 5–7; MacGregor 2014, p. 2.



regulations bring clarity to the question concerning the tax treatment of outbound transfers of intangible assets, including goodwill and going concern value.

Pursuant to the aforesaid final regulations, the exception rule allowing outbound transfers of assets free of taxes, if the assets were transferred to a foreign company for its use in an active business outside the USA, would no longer be applicable to any kind of intangible property whatsoever (not only intangibles mentioned in Section 936(h)(3)(B)), therefore also including goodwill and going concern value.<sup>451</sup> Accordingly, the special treatment of foreign goodwill and going concern value has been removed from the regulations, and all outbound transfers of intangibles are subject to U.S. tax: the intangible assets with the meaning of Section 936(h)(3)(B) under a royalty treatment in Section 367(d), other intangibles not listed in Section 936(h)(3)(B) (such as goodwill and going concern value) either similarly or through the gain recognition regulated in Section 367(a)(1).<sup>452</sup> The Treasury Regulations were validated, among other things, with the need to address the current state, where “certain taxpayers attempt to avoid recognizing gain or income attributable to high-value intangible property by asserting that an inappropriately large share (in many cases, the majority) of the value of the property transferred is foreign goodwill or going concern value that is eligible for favorable treatment under section 367.”<sup>453</sup> Nevertheless, the regulations have been heavily criticized by practitioners, as they have been considered to be inconsistent with the legislative history of Section 367.<sup>454</sup>

From the aforementioned Treasury Regulations results that the transfer pricing treatment of outbound transfers of goodwill and going concern value could have changed correspondingly. This would mean that such transfers would also fall within the scope of the transfer pricing provisions due to the fact that they are subject to the income taxation in otherwise tax-free transactions (reorganizations etc.). This view may be supported by the fact that the new Treasury Regulations discussed above also contain an express reference to Section 482. Pursuant to the regulations, “in cases in which a U.S. transferor's transfer of property to a foreign corporation [in the Section 367 context] constitutes a controlled transaction as defined in § 1.482-1(i)(8), the value of the property transferred is determined in accordance with section 482 and the regulations thereunder.”<sup>455</sup> This indicates that, if an outbound transfer of property subject to tax in accordance with Section 367 is conducted between

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<sup>451</sup> See Treas. Reg. § 1.367(a)-2(a)(2) and § 1.367(a)-2(b).

<sup>452</sup> See Treas. Reg. § 1.367(a)-1(b)(5) and § 1.367(d)-1(c)(3) for more detailed description of the question.

<sup>453</sup> See preamble to the proposed regulations, 70 Fed. Reg. 55570.

<sup>454</sup> See e.g. Yoder 2016, pp. 3–4; Asali – Femia 2016, pp. 8–9.

<sup>455</sup> See Treas. Reg. § 1.367(a)-1(b)(3).

controlled parties, such transfers are primarily subject to the transfer pricing rules and therefore to the arm's length valuation as regulated in Section 482 and corresponding regulations. The preamble of the said regulations confirms this by referring to the Treasury Regulations of Section 482, which in general regulate the coordination of different provisions of the IRC, such as Section 367 and 482.<sup>456</sup>

From this perspective, the IRS thus requires that, if something of value subject to taxation pursuant to the IRC's provisions is transferred between related parties, such as goodwill or going concern value at present, it must be compensated at arm's length in accordance with Section 482 and the Treasury Regulations thereunder. In this sense, the IRS seems to have taken the same approach as it has in *Veritas*,<sup>457</sup> although it did not take a stand in the new regulations on whether goodwill and going concern value should be regarded as intangibles property within the meaning of Section 936(h)(3)(B).<sup>458</sup>

Hence, as a consequence of the above, it is very likely that outbound transfers of both domestic and foreign goodwill/going concern value fall nowadays within the scope of Section 482 of the IRC and corresponding Treasury Regulations. As all outbound transfers of intangibles are now subject to income taxation, and when taking into consideration the IRS's aforementioned Treasury Regulations with references to Section 482 transactions in this connection, such an approach has strong legal grounds. Nonetheless, this interpretation is strict, and also conflicting interpretations of the question are possible under the existing law, i.e. transfers of goodwill and going concern value would not be subject to transfer pricing and Section 482 of the IRC at all, mainly due to *Veritas*. As the findings of the case have not yet been overruled, one could still refer to it. However, in order to avoid possible disputes with the IRS, it is more reasonable to apply the above-mentioned approach, according to which controlled transfers of goodwill and going concern value fall currently within the scope of the U.S. transfer pricing rules. This view is also justified from the perspective of the arm's length principle. As independent parties would usually compensate the value of goodwill/going concern value had the transaction involving transfers thereof

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<sup>456</sup> See 81 Fed. Reg. 91013. Pursuant to the referred regulations, "*a coordinated best method analysis and evaluation of two or more controlled transactions to which one or more provisions of the Code or regulations apply* may be necessary to ensure that the overall value provided, including any synergies, is properly taken into account"; see Treas. Reg. § 1.482-1T(f)(2)(i)(C). More importantly, the regulations further confirm the above mentioned by stating that "*all value* provided between controlled taxpayers in a controlled transaction requires an arm's length amount of compensation"; see Treas. Reg. § 1.482-1T(f)(2)(i)(A).

<sup>457</sup> This view has been shared also in Penelle – Varley – Hawes 2017, pp. 3–4.

<sup>458</sup> 81 Fed. Reg. 91013.

occurred between them, and when also taking into consideration that outbound transfers of such assets are subject to taxation, related parties are thus in the same position as unrelated parties. The approach is also in line with the Finnish OECD based approach.

Nevertheless, the current situation can be criticized. The existing tax and transfer pricing rules cause unnecessary interpretive problems. The transfer pricing treatment of this particular transfer pricing question is not foreseeable, because of the lack of express mentions of goodwill/going concern value even in the newest Treasury Regulations and the fact that *Veritas* has not been yet overruled. Hence, there is a clear need for either new court decisions or amendments to the Treasury Regulations to clarify eventually, whether goodwill and going concern value may be regarded as intangibles for the purpose of Section 482. One alternative could be that goodwill and going concern value would be expressly regulated as types of intangible property in Section 936(h)(3)(B)) of the IRC and corresponding Treasury Regulations interpreting Section 482.

On the other hand, to discuss whether transfers of goodwill and going concern value could fall within scope of application of the U.S. transfer pricing rules as *separate items* in business restructurings, they should also be distinguishable from other possible asset transfers occurring in the course of a business restructuring as well as that they should have separate commercial value, which would be compensated in transactions between independent parties. As it can be seen from the definitions of the concepts of goodwill and going concern value under U.S. law above, they are closely linked to an operational value of an on-going business, and in this sense have clearly commercial value. However, the value regarded as goodwill and/or going concern value arises from the existence of a going concern/business, and therefore it cannot be present alone or separately from such a business. It is also generally regarded in the legislation and regulations<sup>459</sup> as well as the legal literature<sup>460</sup> that goodwill and going concern value lack the ability to be valued and transferred separately from a business.

Thus, although the outbound transfers of goodwill and going concern value would be considered to fall within the scope of application of the U.S. transfer pricing rules pursuant to the new regulations in the above-discussed manner, that would not result in that transfers of goodwill and going concern value could be subject to transfer pricing in business restructurings *as separate items*, as they cannot be transferred separately from a business. On the other

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<sup>459</sup> See e.g. Section 1060 of the IRC and Treas. Reg. § 1.1060-1(b)(2)(ii). See also former § 1.367(a)-1T(D)(5)(iii) discussed earlier.

<sup>460</sup> See e.g. Zollo 2011, pp. 770–771; Asali – Femia 2016, p. 6.

hand, when a functioning business unit, going concern, is transferred in a business restructuring, goodwill and going concern value should be taken into consideration in the transfer pricing analysis as a part of the transferring business unit, because the transfer pricing valuation in that case shall be made on an aggregate basis.

Despite the lack of clarity on the current legal state, at least to a certain degree, U.S. law and Finnish law seem to be in line with each other in terms of transfer pricing of goodwill and going concern value. Due to the nature of the assets, goodwill and going concern value lack the ability of being transferred separately from other assets. As business restructurings can be regarded for transfer pricing purposes as transfers of a going concern under both countries' laws, such intangibles should be included in the transfer pricing analysis of a going concern. As discussed, this approach is in line with the arm's length principle, as independent parties would also very likely remunerate transfers of such assets as a part of business valuation in comparable situations.<sup>461</sup> Nonetheless, as business restructurings may not be considered transfers of a going concern under Russian law, transactions involving transfers of goodwill/going concern value fall outside the scope of the Russian transfer pricing provisions. Thus, related parties are treated differently in comparison with independent parties — which is against the whole purpose of the arm's length principle — and therefore new regulation should be adopted in Russia in this respect.

### **3.6.6 OTHER INTANGIBLE ASSETS**

Intellectual property rights, know-how and trade secrets as well as goodwill and going concern value are not the only intangible assets transferable from a group company to another in business restructurings. It is also possible that a business restructuring involves transfers of intangibles, which are not legally protected by national regulations and/or recorded on a company's balance sheet.<sup>462</sup> Nevertheless, transfers of such intangible assets also must be taken into consideration when business restructurings are examined from a transfer pricing perspective.

IFRS 3 standard, for instance, can be helpful in pointing out intangible assets, which may not be recorded on companies' balance sheets but may still be transferred in business restructurings from one group company to another. Although IFRS 3 concerns business combinations, not business restructurings, the intangible assets transferred in both kinds of transactions

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<sup>461</sup> OECD Transfer Pricing Guidelines, 6.27–6.28, 9.68–9.70.

<sup>462</sup> OECD Transfer Pricing Guidelines, 9.55.

may be similar or even the same. IFRS 3 lists, among other things, intangible assets related to customers, technology and agreements, such as customer lists and relationships, unpatented technologies and construction licenses.<sup>463</sup>

According to the OECD Transfer Pricing Guidelines, in the transfer pricing analysis of a business restructuring it is essential to identify all the relevant intangible assets or rights in intangibles, which have been transferred in the restructuring between related parties, after which it must be examined whether independent parties would compensate such transfers in transactions under similar circumstances. Provided that these requirements are met, such transfers shall be subject to transfer pricing in accordance with the arm's length principle. To name a few, the OECD explicitly mentions customer lists, distribution channels and contractual rights as examples of these kinds of intangible assets, which could be transferred specifically in the business restructuring context.<sup>464</sup>

As it was discussed earlier, Chapter VI of the OECD Transfer Pricing Guidelines defines the concept of intangible asset broadly for transfer pricing purposes, and it may cover a wide range of valuable non-physical assets that are used in commercial activities and whose transfer would be remunerated in transactions conducted between independent parties. This may include also intangibles, which are not recognized as intangible properties in accounting.<sup>465</sup> Thus, apart from the above-mentioned intellectual property rights, goodwill and going concern value, such intangibles may also be, *inter alia*, government licenses and concessions.<sup>466</sup> Therefore, the intangible assets, which must be taken into consideration in the transfer pricing analysis of a business restructuring, are not limited only to the assets, which are expressly mentioned in Chapter IX of the OECD Transfer Pricing Guidelines, but also transfers of any other intangible assets falling under the broad definition of intangible asset must be taken into account.<sup>467</sup>

It may be considered highly unlikely that the said intangible assets and transfers thereof would currently become objects of transfer pricing in Russia. The Minfin's and the FTS's interpretations of stretching the scope of application of the transfer pricing provisions to transfers of intellectual property rights cannot be applied to other intangible assets. Although transfers of these kinds of intangible assets could be identified and separated

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<sup>463</sup> IFRS 3, Appendix B, B31–B34. See in more detail e.g. Catty 2010, pp. 244–246.

<sup>464</sup> OECD Transfer Pricing Guidelines, 9.55 and 9.66.

<sup>465</sup> OECD Transfer Pricing Guidelines, 6.6 and 6.7.

<sup>466</sup> OECD Transfer Pricing Guidelines, 6.24.

<sup>467</sup> For this purpose, Chapter IX's regulations with regard to transferring intangibles in the business restructuring context expressly refer to Chapter VI; see OECD Transfer Pricing Guidelines, 9.56.

from other transferred assets in business restructurings and they would have the kind of commercial value that would be compensated in transactions between independent parties under similar conditions, they are not by nature intellectual properties under Russian law. That would require that they would be defined and protected as intellectual properties in the Civil Code. The aforesaid view is supported by the fact that also tax practitioners are of the opinion that transfers of such intangible assets do not have to be taken into account, when transfer pricing provisions are applied in practice. They have validated this approach by referring to the Tax Code's new transfer pricing rules, which do not expressly deal with transfers of these types of assets.<sup>468</sup> Moreover, no contradictory interpretations of the question can be found from other legal sources.

Thus, as it stands, transfers of such intangible assets that are not legally protected as intellectual properties under Russian law cannot fall within the scope of application of the Russian transfer pricing regulations, when occurring in the course of business restructurings. The IFRS 3 accounting standard, as well as the OECD Transfer Pricing Guidelines, therefore provide an excellent demonstration of intangible assets, which in general may be transferred in business restructurings between related parties, but which also very likely fall outside the scope of application of the Russian transfer pricing provisions, except for intellectual properties.

It was already previously discussed that the existing situation in Russia in this regard is troublesome. One may criticize why the Tax Code has not dealt with the transfer pricing aspects of intangibles at all, as the newest transfer pricing regulations in general follow the principles of the OECD Transfer Pricing Guidelines. Furthermore, in light of the current Tax Code's provisions, no reasons are evident why the FTS and the Minfin have come to the conclusion that controlled transfers of intellectual properties fall within the scope of the Tax Code's transfer pricing rules, while the applicability of the rules to transfers of intangibles generally remain unconsidered and undiscussed. This, in turn, creates problems from the perspective of the arm's length principle. Other intangibles may also have commercial value that would be compensated in transactions between independent parties, such as the above-mentioned customer lists and permits. In consequence, related parties and independent parties are now treated differently, which is contrary to the whole purpose of the arm's length principle. Hence, there are needs for improvements *de lege ferenda* in the legislation in this respect.

In contrast to Russia, the intangibles falling within the scope of application of the Finnish transfer pricing provisions are not limited to legally protected

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<sup>468</sup> Expert Interview 2012.

intellectual property rights. As a starting point, transactions involving transfers of intangible assets are generally in the scope of the Finnish transfer pricing provisions pursuant to the preliminary works of the AAP<sup>469</sup> and the Tax Administration's memorandum<sup>470</sup>. The precise definition of intangible asset under Finnish law has been left open for transfer pricing purposes. It is noteworthy to observe that, pursuant to the preliminary works, among other things, the earlier mentioned customer lists and distribution channels are regarded as intangible assets subject to transfer pricing.<sup>471</sup> Furthermore, the Tax Administration's memorandum confirms this and also mentions other examples of intangible assets, such as production and manufacturing networks and other similar assets difficult to determine or define. According to the memorandum, the concept of intangible property must be understood broadly, and attention must be paid as to whether the asset in question would constitute profits in transactions between independent parties. Although the asset cannot be registered or lacks transferability, it may be considered an intangible asset for transfer pricing purposes.<sup>472</sup> Finnish law is thus in line with the above-mentioned provisions of the OECD Transfer Pricing Guidelines: the decisive factor is ultimately whether unrelated parties would compensate transfers of such assets in corresponding conditions.

As there are no discrepancies between Finnish law and the OECD Transfer Pricing Guidelines in this respect, the above-discussed Chapter IX's guidance should primarily be followed also in Finland, as it contains specific rules on the transfer pricing of intangibles in the business restructuring context. First, this means that the concept of intangible asset must be understood broadly for transfer pricing purposes, and all transfers of relevant intangibles or rights in intangibles must be identified and separated from other possible transfers occurring in the course of a business restructuring in order to become separate objects of transfer pricing.<sup>473</sup> The intangible assets, which could potentially fall within the scope of application of the Finnish transfer pricing rules, should not be limited to the examples of intangibles provided in the OECD Transfer Pricing Guidelines and the Finnish sources of law above.

Second, when all transactions involving transfers of relevant intangible properties have been identified in the above-discussed manner, especially of great importance is to examine whether independent parties would compensate transfers of such intangibles in their transactions under similar circumstances. If this is the case, such transfers should primarily fall within

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<sup>469</sup> HE 107/2006 vp, p. 20.

<sup>470</sup> Finnish Tax Administration Memorandum 1471/37/2007, p. 24.

<sup>471</sup> HE 107/2006 vp, p. 16.

<sup>472</sup> Finnish Tax Administration Memorandum 1471/37/2007, p. 24.

<sup>473</sup> OECD Transfer Pricing Guidelines, 9.55.

the scope of application of the Finnish transfer pricing provisions in the business restructuring, and an arm's length compensation for such transfers should be determined accordingly.<sup>474</sup> The transfer pricing analysis must be therefore done on a transaction-by-transaction/asset-by-asset basis.

A wider range of intangible assets are likely to fall within the scope of application of the national transfer pricing rules in cross-border business restructurings as separate items under Finnish law as compared to Russian law, as the concept of intangibles must be understood broadly. Moreover, it must be noted that some intangibles, transfers of which would be remunerated in transactions between unrelated parties, may not necessarily be separated from a complex of assets, a business unit. Such assets should be taken into account correspondingly, when an arm's length compensation is determined for the transfer of a going concern occurred in the business restructuring.<sup>475</sup> Contrary to Russia, the arm's length principle is hence followed effectively in business restructuring cases involving transfers of intangibles in general (not only legally protected intangibles or intangibles recorded in the balance sheet). This is mainly a result of the broad definition of intangible asset applied in Finland for transfer pricing purposes, which always requires the aforementioned examination of whether independent parties would compensate transfers of such assets in comparable circumstances.

As discussed, the forms of intangible property subject to transfer pricing under the U.S. transfer pricing provisions are listed in detail in Section 936(h)(3)(B) of the IRC and the corresponding Treasury Regulations.<sup>476</sup> In addition to the aforementioned intellectual property rights, know-how and information that may be regarded as trade secret (formulas, patterns etc.), also other type of assets may be considered as intangible property for the purposes of Section 482. These assets — which conform to a large extent to the examples mentioned in the OECD Transfer Pricing Guidelines and the sources of Finnish law above — may be, among other things, franchises, licenses, contracts, campaigns, surveys, studies, forecasts, estimates, customer lists and technical data.<sup>477</sup>

It must be noted that the list is not exhaustive, and therefore “other similar items” are also regarded as intangible property for the purposes of Section 482. As it was discussed earlier, an item is considered similar “if it derives its value not from its physical attributes but from its intellectual content or other

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<sup>474</sup> OECD Transfer Pricing Guidelines, 9.55.

<sup>475</sup> OECD Transfer Pricing Guidelines, 9.68–9.69.

<sup>476</sup> See Treas. Reg. § 1.482-4(b).

<sup>477</sup> Treas. Reg. § 1.482-4(b)(4)–(5).



intangible properties.”<sup>478</sup> In this sense, the concept of intangible property for transfer pricing purposes must be understood broadly also under U.S. law. Nevertheless, there ambiguity may exist as to whether certain intangible assets meet the requirements of being “other similar items” for the purposes of Section 482. As was the case with goodwill and going concern value, the IRS and the Tax Court may interpret the same issue differently for transfer pricing purposes.<sup>479</sup> As the outbound transfers of intangible assets are at present subject to income taxation even in cases, where transactions would otherwise be qualified for a tax-free treatment,<sup>480</sup> this strongly indicates that the IRS may require that an arm’s length compensation must nowadays be paid in general

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<sup>478</sup> See Treas. Reg. § 1.482-4(b)(6).

<sup>479</sup> It must be observed that, in recent years, the transfer pricing treatment of the so-called *workforce in place* has been of great interest in the U.S. transfer pricing. Workforce in place, or assembled workforce, includes “the composition of a workforce (for example, the experience, education, or training of a workforce), the terms and conditions of employment whether contractual or otherwise, and any other value placed on employees or any of their attributes,” see Treas. Reg. § 1.197-2(b)(3). Workforce in place has not been listed as a form of intangible property under Section 936(h)(3)(B) of the IRC, and therefore taxpayers have been of the opinion that it may not be subject to the transfer pricing rules. On the contrary, the IRS has regarded workforce in place as “other similar item” and accordingly as intangible property subject to U.S. tax and transfer pricing. In *Veritas*, the Tax Court ruled that goodwill, going concern value and workforce in place may not be considered intangible properties within the definition set forth in Section 936(h)(3)(B) of the IRC and therefore for transfer pricing purposes. As it was discussed earlier, the IRS disagreed with the ruling and regarded it erroneous, and thus there still exists to some extent unclarity as to whether workforce in place can be regarded as intangible property for transfer pricing purposes; see Fuller – Bassett – Skinner 2007, pp. 16–19; Silverman – Kidder – Gordon 2014, pp. 226–233; Oates – O’Brien 2013, pp. 6–9; Yoder 2012, p. 4.

The Obama Administration proposed changes in the legislation that would address the current unclear situation by suggesting that workforce in place should be included in the definition of intangible property for Section 482 purposes. However, any actual legislative changes have not been yet enacted on the basis of the proposal; see Silverman – Kidder – Gordon 2014, pp. 232–233; Anson – Bress – Dubert – Collins – Quinn – Lubkin 2009, pp. 1–4. Nevertheless, as goodwill and going concern value do not qualify anymore for the exception rule (active business outside the USA) under Section 367 of the IRC, and correspondingly outbound transfers of intangible assets are in general subject to taxation at present, this may mean that, similar to goodwill and going concern value, also workforce in place may be nowadays regarded as a target of transfer pricing – at least by the IRS. In this respect, U.S. law deviates from the OECD Transfer Pricing Guidelines and consequently from Finnish law, as the OECD Transfer Pricing Guidelines has dealt with assembled workforce only as a factor which must be taken into account in the comparability analysis and ultimately in determining the arm’s length value in particular for a transfer of a going concern; see OECD Transfer Pricing Guidelines, 1.152–1.153, 6.138, 9.68.

<sup>480</sup> See the earlier discussed Treas. Reg. § 1.367(a)-1(b)(5), § 1.367(a)-2(a)(2), § 1.367(a)-2(b) and § 1.367(d)-1(c)(3).

for controlled transfers of intangibles, provided that such transfers would be compensated in transactions executed between independent parties.<sup>481</sup>

In the business restructuring context, the above mentioned means that, as was the case in Finland, taxpayers should first identify all noteworthy transfers of intangible property occurring in the course of a business restructuring. In particular, if the restructuring involves transfers of intangible property listed expressly under Section 936(h)(3)(B) of the IRC and the Treasury Regulations, such transfers will primarily fall within the scope of application of the U.S. transfer pricing rules, if they would be remunerated between unrelated parties in the given circumstances. However, related parties must also identify any other transfers of intangibles, which could be regarded as “other similar items” in accordance with the Treasury Regulations. This requires that transfers of such assets are diligently examined on a transaction-by-transaction basis. After the successful identification of such intangible assets, it must be reviewed whether independent parties would compensate the transfers of these intangible assets in their transactions in similar conditions. If both requirements are met, such transfers of intangible property will also likely fall within the scope of application of the U.S. transfer pricing rules in that particular business restructuring, meaning that such transfers must be compensated at arm’s length. Similar to Finland, if such assets having commercial value may not be separated from a complex of assets, they should be subject to transfer pricing as a part of the going concern transferred in the business restructuring.

It seems that a broad definition of intangible property for transfer pricing purposes, which does not aim at exhaustively determining all the asset types falling within the scope of the concept, brings good results in terms of the arm’s length principle. As Finland and the USA apply this approach, the decision on whether some intangibles fall within the scope of the transfer pricing rules will be made ultimately on a case-by-case basis, taking into consideration whether independent parties would compensate transfers of such non-physical assets in comparable circumstances. That kind of analysis brings a taxpayer closer to an arm’s length result in comparison with situations where the intangible assets subject to transfer pricing would be listed in the national legislation exhaustively. The concept of intangible property is broad; consequently, it is a difficult, or even impossible, task to explicitly determine all the intangible assets that could be deemed to be objects of transfer pricing.

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<sup>481</sup> The arm’s length standard also requires that the results of a related party transaction are consistent with the results that would have been realized if independent parties would have engaged in the same transaction under the same circumstances, see Treas. Reg. § 1.482-1(b)(1). This basically means that an arm’s length compensation must be paid as a general rule for transfers, which would be compensated in transactions between independent parties.

However, like in Finland, certain matters remain subject to interpretation when the concept of intangible assets is understood broadly. Especially under U.S. law, the reference to “other similar items” in the regulations may prove to be troublesome in certain cases, as it can be seen above from the question with respect to transfer pricing of goodwill and going concern value. Similar interpretive problems may arise in the Finnish, OECD-based, approach, if it is unclear in a given case whether transfers of certain items or assets should be regarded as intangibles and consequently be compensated at arm’s length. Nevertheless, the list of expressly mentioned intangibles in the U.S. regulations as well as the examples of the OECD already cover a wide range of intangible assets that are usually compensated in transactions between independent parties, and therefore this observation is rather theoretical (except for the mentioned goodwill and going concern value in the USA).

As, in the current situation, the determination of all asset types falling within the scope of the concept of intangible assets is likely impossible, the existing Finnish and U.S. transfer pricing rules are largely efficient in terms of the arm’s length principle. In order to improve the compliance with the aims of the arm’s length principle, the current rules could be amended *de lege ferenda* to address the aforementioned ambiguous situations, if certain measures could be found, without unnecessarily limiting the scope of the concept of intangible assets. Quite the contrary, the Russian rules do not practically require complying with the arm’s length principle in the current situation at all, due to the lack of relevant regulations in this regard. Hence, as discussed, there are urgent needs for improvements *de lege ferenda* in Russia in this respect.

### 3.7 TRANSFER OF RISKS

Business restructuring was earlier defined, *inter alia*, as a cross-border restructuring of a multinational enterprise’s risks, activities and assets. Transfer of *risks* is therefore also a transfer pricing question of great importance in business restructurings. Risks often relate to profit generation as well as to expected returns on investments.<sup>482</sup> When business models and strategies are amended, it is not unusual that some of the local activities of a multinational enterprise are also converted into low-risk operations. Consequently, the local group company’s profit will be relatively low in the future, as the entrepreneurial risks are now borne by another group company, which is entitled to profit in accordance with the (increased) entrepreneurial

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<sup>482</sup> Kroppen – Silva 2011, p. 34.

risks.<sup>483</sup> In the legal literature, it has been discussed whether transfers of risks could fall within the scope of transfer pricing regulations in business restructurings, when a group company transfers them and simultaneously gives away a part of its future revenue to another company. Furthermore, it has been explored whether transfers of risks can alone be subject to transfer pricing.<sup>484</sup> It should also be noted that risks have been regarded as intangible assets in some countries; however, this kind of approach is very exceptional.<sup>485</sup> This section will examine whether transfers of risks may fall within the scope of the national transfer pricing provisions in Russia, Finland and the USA as separate items on a stand-alone basis in connection with cross-border business restructurings, or should they be taken into account in some other way in the context of restructurings.<sup>486</sup>

The OECD Transfer Pricing Guidelines pay special attention to transfers of risks between associated companies in the business restructuring context. Pursuant to the guidelines, the allocation of risks between related parties should be examined and analyzed before and after the business restructuring in connection with the functional analysis, as it helps to identify whether any economically significant risks, i.e. risks that carry significant profit potential, related to the restructured business have been transferred.<sup>487</sup> Chapter IX provisions specifically refer to the new risk analysis guidance in Section D.1.2.1 of Chapter I of the OECD Transfer Pricing Guidelines, which were introduced just recently in 2015 as a result of the BEPS Project and which regulate the risk analysis in more detail.<sup>488</sup>

According to the general guidance, by identifying the risks assumed by the parties in a controlled transaction, it helps to determine whether the compensation paid in the transaction is comparable to compensations paid in transactions between independent parties and whether it is thus arm'

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<sup>483</sup> OECD Transfer Pricing Guidelines, 9.19.

<sup>484</sup> Kroppen – Silva 2011, p. 34.

<sup>485</sup> See PwC 2007, p. 6, which has more of an informative character.

<sup>486</sup> As risks relate to potential profit generation and expected profits in the above-mentioned manner, also transfers of such profit potential as part of or in conjunction with transfers of risks will be discussed herein. Also, the OECD has discussed the allocation of risks and profit potential together in the context of business restructurings, see OECD Transfer Pricing Guidelines, 9.39–9.47. Pursuant to the OECD, profit potential means expected future profits; see OECD Transfer Pricing Guidelines, 9.40.

<sup>487</sup> OECD Transfer Pricing Guidelines, 9.19–9.20, 9.22. “The significance of a risk will depend on the likelihood of the risk materialising and the size of the potential profits or losses arising from the risk,” see OECD Transfer Pricing Guidelines, 9.22.

<sup>488</sup> It should be noted that risk is not regarded as intangible asset under the guidelines, but is defined as “the effect of uncertainty on the objectives of the business”; see OECD Transfer Pricing Guidelines, 1.71.

length.<sup>489</sup> The guidelines require that economically significant risks should be identified with specificity in related party transactions, in this case, in business restructurings, and this must be done both before and after the restructuring.<sup>490</sup> Both the contractual terms and the conduct of the parties (i.e. whether contractual terms are followed by the parties) must be examined in order to determine, which controlled party assumes certain risks before and after the restructuring.<sup>491</sup> Subsequently, it must be reviewed whether the related party, which assumes the risks in the particular case on the basis of the contractual terms/conduct, “exercises control over the risk and has the financial capacity to assume risk.” If the party does not have the actual control over the risk or the financial capacity to assume it, the risk must be allocated to the party that has the *de facto* control and financial capacity.<sup>492</sup> The actual related party transaction in question should, as accurately delineated, be ultimately priced in accordance with the arm’s length principle taking into consideration the risks assumed and allocated on the basis of the risk analysis. The party, which assumes and/or mitigates risks, should be entitled to an appropriate remuneration in such a transaction.<sup>493</sup>

It must be observed that the determination of the economically significant risks therefore relates to, in essence, examining how risks may have an impact on the pricing of a controlled transaction. The risk analysis helps to determine the comparability between a related party transaction and a similar transaction (with similar risks) conducted between unrelated parties — and ultimately the arm’s length compensation.<sup>494</sup> The risk analysis is, as discussed, a part of the functional analysis, which is in turn a part of the comparability analysis. By identifying the economically significant activities and functions performed by the related parties, including the risks assumed, it helps to determine whether the controlled transaction is comparable to uncontrolled party transactions (and eventually arm’s length), as the compensation generally reflects such functions and activities performed.<sup>495</sup>

The OECD Transfer Pricing Guidelines’ starting point is that the transfers of risks and profit potential, which is usually transferred along with the risks, should be examined as part of the transfers of other assets/going concern or as part of the possible termination or renegotiation of existing agreements, which could be potentially remunerated in a related party transaction in the

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<sup>489</sup> OECD Transfer Pricing Guidelines, 1.51, 1.56–1.60, 1.73, 1.100, 9.19.

<sup>490</sup> OECD Transfer Pricing Guidelines, 1.60, 1.71–1.72, 9.22.

<sup>491</sup> OECD Transfer Pricing Guidelines, 1.77–1.82, 9.20–9.21.

<sup>492</sup> OECD Transfer Pricing Guidelines, 1.98–1.99, 9.20–9.21.

<sup>493</sup> OECD Transfer Pricing Guidelines, 1.60, 1.100.

<sup>494</sup> OECD Transfer Pricing Guidelines, 1.73, 1.100.

<sup>495</sup> OECD Transfer Pricing Guidelines, 1.33, 1.36, 1.51, 1.56.

course of a business restructuring. Risks and profit potential are not thus considered objects of transfer pricing separately but they must be taken into account in the above-mentioned manner, when arm's length compensations are determined for transfers of assets/going concern or for the termination or substantial renegotiation of existing agreements during a business restructuring.<sup>496</sup> According to the OECD Transfer Pricing Guidelines,

“An independent enterprise does not necessarily receive compensation when a change in its business arrangements results in a reduction in its profit potential or expected future profits. The arm's length principle does not require compensation for a mere decrease in the expectation of an entity's future profits. When applying the arm's length principle to business restructurings, the question is whether there is a transfer of something of value (an asset or an ongoing concern) or a termination or substantial renegotiation of existing arrangements and that transfer, termination or substantial renegotiation would be compensated between independent parties in comparable circumstances. ---

--- The notion of “profit potential” is often used for valuation purposes, in the determination of an arm's length compensation for a transfer of intangibles or of an ongoing concern, or in the determination of an arm's length indemnification for the termination or substantial renegotiation of existing arrangements, once it is found that such compensation or indemnification would have taken place between independent parties in comparable circumstances.”<sup>497</sup>

Is the existing legal state in Russia consistent with the OECD Transfer Pricing Guidelines' approach, when it comes to the transfer pricing of risks and associated profit potential? First, the question of whether the actual transfers of risks and possible profit potential may become objects of transfer pricing regulations in Russia seems to be unproblematic in terms of interpretation of existing law. The risks and profit potential are not protected as intellectual properties under the Civil Code;<sup>498</sup> in addition, the Tax Code does not include specific provisions concerning their transfers. Strictly from this perspective, it could be stated that it is very likely that transfers of risks/profit potential do not fall within the scope of application of the transfer pricing rules — just like, for instance, the previously discussed intangible assets listed in IFRS 3.

This view can be supported by the fact that, in the legal literature, risks have not been considered as assets falling within the scope of the transfer pricing

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<sup>496</sup> See OECD Transfer Pricing Guidelines, 9.39–9.46.

<sup>497</sup> OECD Transfer Pricing Guidelines, 9.39–9.40.

<sup>498</sup> See Article 1225 of the Civil Code.

regulations even during the former transfer pricing legislation.<sup>499</sup> As the new transfer pricing rules did not bring any substantial changes in this respect, there is no reason to change this interpretation. In addition, tax practitioners have not considered it appropriate to require an arm's length compensation in situations that involve merely controlled transfers of risks. It has been acknowledged that the tax authorities may be willing to intervene in such related party transactions concerning transfers of assets, which directly affect the amount of income and/or losses of the controlled companies and where the authorities also disagree on the allocation of the income. The transfers of risks, however, have not been considered to have such a direct effect on the taxable income that it should be alone compensated. When also taking into account that no legal support can be found from tax law sources in relation to applying the arm's length principle solely to transfers of risks (profit potential), they have been left outside the scope of the application of the Russian transfer pricing regulations in practice.<sup>500</sup>

Nonetheless, this does not mean that transfers of risks should not be taken into consideration at all in the transfer pricing of business restructurings under Russian law. As mentioned, when a business restructuring is examined from a transfer pricing perspective, the related parties should analyze and identify in the functional analysis transactions, which occur between them in the course of the business restructuring. This consists of analyzing and identifying, among other things, the risks of the related companies before and after the restructuring. In the transfer pricing documentation, it is recommended to characterize what type of companies have participated in the related party transactions in terms of risks. In that case, related parties can be described as, for instance, fully-fledged distributors, limited risk distributors and commissionaires.<sup>501</sup> The analysis of risks in this sense helps the parties to understand the whole structure of the business restructuring and, in particular, what kinds of transactions have been performed in the business restructuring,<sup>502</sup> although transfers of risks and profit potential do not fall within the scope of application of the Russian transfer pricing rules as such.

The Tax Code lists different types of risks that may be assumed by controlled parties in related party transactions — for instance, inventory risks, foreign currency risks, credit risks and environmental risks — and that must therefore be taken into consideration in the functional analysis. As the functional analysis is a part of the comparability analysis under Russian tax law, these

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<sup>499</sup> See e.g. Evdokimov – Konnov 2011, p. 632.

<sup>500</sup> Expert Interview 2012.

<sup>501</sup> Pis'mo Federal'noj nalogovoj sluzhby Rossii ot 30.08.2012 N OA-4-13/14433@ "O podgotovke i predstavlenii dokumentatsii v tselyakh nalogovogo kontrolya."

<sup>502</sup> Article 105.5 the Tax Code.

kinds of risks should be taken into account in the end, when related party transactions are compared to transactions executed between independent parties.<sup>503</sup> As discussed, in the comparability analysis the related parties must compare the commercial conditions of their transaction to the commercial conditions of transactions between independent parties under similar circumstances. The ultimate purpose of the comparability analysis is to verify that the arm's length compensation in a controlled transaction corresponds to transfer prices used in transactions between independent parties under similar economic circumstances — which also means under similar risks.

Thus, even though transfers of risks will not, on the above-mentioned grounds, become objects of transfer pricing under Russian tax law, they cannot be entirely ignored, when business restructurings are examined from a transfer pricing perspective. Related parties must identify and analyze possible transfers of risks in the course of a business restructuring in order to understand the conducted transaction(s) in the functional analysis and to perform the comparability analysis with the aim to determine the arm's length compensations for the transfers of assets and something of value in the business restructuring. Nonetheless, the current legal status in Russia does not deviate much from what has been regulated in the OECD Transfer Pricing Guidelines. Moreover, Russian law entitles the authorities in general to intervene in arrangements in which the form of the transaction does not correspond to the real economic substance, which means that they may also reallocate the risks between related parties, if parties' conduct does not conform to the contractual terms, similar to the aforesaid provisions of the OECD Transfer Pricing Guidelines.<sup>504</sup>

As Finland follows the OECD Transfer Pricing Guidelines — including Chapter IX — to a great extent in practice, should the above-mentioned guidelines' approach to transfers of risks and associated profit potential be taken as the starting point also under Finnish law? This would mean that transfers of risks and consequently profit potential would not fall within the scope of application of the Finnish transfer pricing rules as separate items in business restructurings, but they should be taken into account in determining the arm's length compensation for transfers of assets or going concern and/or the

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<sup>503</sup> Ibid.

<sup>504</sup> The authorities' actions can be based on the provisions of the Russian Civil Code regulating, for example, sham transactions; see Article 170 of the Civil Code. In addition, the tax authorities may refer to the so-called principle of unjustified tax benefit developed in the legal praxis of the Supreme Commercial Court; see the decisions *Postanovlenie Plenuma Vysshego Arbitrazhnogo suda Rossijskoj Federatsii ot 12 oktyabrya 2006 goda N 53 "Ob otsenke arbitrazhnymi sudami obosnovannosti polucheniya nalogoplatel'shnikom nalogovoj vygody"* and *Opredelenie Vysshego Arbitrazhnogo Suda RF ot 11 yanvarya 2009 g. N 16307/08*.



termination or renegotiation of existing agreements occurred in the course of a business restructuring.

This view could be supported by the fact that § 31 of the AAP and related preliminary works do not expressly mention transfers of risks or profit potential as transaction types subject to the transfer pricing provisions as separate items. Pursuant to the preliminary works, § 31 of the AAP should be applied to transactions, which are understood in general as commercial actions performed in business and other commercial activity, such as typical sale and purchase transactions, financial arrangements and transfers of intangibles.<sup>505</sup> It is unlikely that transfers of risks attached with profit potential could alone be regarded as such commercial actions, as it is unusual that solely risks are, or even could be, transferred in business activities. This view can also be justified by referring to the Finnish Tax Administration's memorandum, which has not discussed the possibility of regarding transfers of risks and profit potential as transaction types falling within the scope of application of § 31 of the AAP.<sup>506</sup> The preliminary rulings practice of the Finnish Large Taxpayers' Office also supports the aforementioned view, as transfers of risks and associated profit potential have not been deemed to be objects of transfer pricing separately in the business restructuring context.<sup>507</sup>

Furthermore, as discussed earlier, transfers of intangibles are generally within the scope of the Finnish transfer pricing rules. However, risks have not been expressly mentioned as intangible properties subject to transfer pricing in the preliminary works and the Tax Administration's memorandum,<sup>508</sup> and overall no support can be found for the view that risks could be regarded as intangible property under Finnish tax law for transfer pricing purposes. As they are not regarded as intangibles under the OECD Transfer Pricing Guidelines either,<sup>509</sup> transfers of risks and profit potential cannot not fall within the scope of application of the Finnish transfer pricing rules as separate items also from this perspective.

The opinions presented in the Finnish legal literature also support the view according to which transfers of risks, and related profit potential, may not be objects of transfer pricing separately, but must be taken into account in the transfer pricing analysis of a business restructuring and in particular in the determination of arm's length compensations for controlled transactions performed in the restructuring. It has been considered that potential transfers

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<sup>505</sup> HE 107/2006 vp, p. 20.

<sup>506</sup> See Finnish Tax Administration Memorandum 1471/37/2007, p. 20.

<sup>507</sup> Laaksonen 2006, pp. 432–433, 436.

<sup>508</sup> See HE 107/2006 vp, p. 16; Finnish Tax Administration Memorandum 1471/37/2007, p. 24.

<sup>509</sup> See the previously mentioned OECD Transfer Pricing Guidelines, 1.71.

of risks occurred in business restructurings must be examined in connection with the transferred or amended function, such as manufacturing activities. In such cases, it is not sufficient to compensate just a transfer of something of value, but also the changes in the risk allocation (and possible profit potential) may have an impact on the determination of an arm's length compensation, and therefore they must be taken into consideration, for example, when determining compensations for transfers of assets or a going concern.<sup>510</sup> Similarly, it has been viewed that, when a business restructuring involves a transfer of a going concern, it is likely that profit potential is included in the arm's length valuation of the whole business unit. On the other hand, if the functioning business unit alternatively would not have been transferred, it would be unlikely, especially from the perspective of the OECD Transfer Pricing Guidelines, that solely a transfer of a profit potential could be an object of transfer pricing.<sup>511</sup>

On the other hand, the Finnish transfer pricing provisions have not ignored the relevance of risks in the transfer pricing analysis of transactions entirely. Both the AAP and the Finnish Tax Administration's memorandum acknowledge the importance of risks in performing the functional analysis. As it was mentioned earlier, the concept of functional analysis referred to in § 14 b of the AAP means a description and analysis of the functions of related parties in a controlled transaction, taking into account the assets used and the risks assumed in the transaction. Ultimately, the functional analysis (including the risk analysis) relates to examining the comparability of controlled and uncontrolled transactions in the comparability analysis as regulated in the OECD Transfer Pricing Guidelines.<sup>512</sup>

Pursuant to the Finnish Tax Administration's guidance, the functional analysis is of great relevance especially in business restructurings, which leads to the fact that the analysis of the allocation of risks also becomes more emphasized in business restructurings. More importantly, it has been expressly highlighted in the Finnish Tax Administration's memorandum that potential changes in the risks assumed by related parties as a result of the business restructuring must be described in the functional analysis. In addition, the Tax Administration describes different kinds of business types and related risks, which must be taken into account in performing both the functional and comparability analyses, such as market risks.<sup>513</sup> These risks are consistent with

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<sup>510</sup> Juusela – Tuominen 2011, pp. 316–317, 319, 322.

<sup>511</sup> Knuutinen 2015, pp. 1066–1067.

<sup>512</sup> HE 107/2006 vp, pp 15–16.

<sup>513</sup> Finnish Tax Administration Memorandum 1471/37/2007, pp. 23 and 25–26. See also HE 107/2006 vp, p. 16.

those risks discussed in the OECD Transfer Pricing Guidelines.<sup>514</sup> Therefore, the allocation of risks in business restructurings must be observed in the functional and comparability analyses, and must be consequently taken into consideration in the determination of an arm's length compensation for transfers of assets/something of value. Hence, Finnish law conforms to the OECD Transfer Pricing Guidelines, as well as to Russian law, in this regard. As the Tax Administration has stated that the OECD's new guidance resulting from the BEPS Project brings no material changes and therefore may be used as a source of reference,<sup>515</sup> the new guidance discussed above with regard to the risk analysis as well as the reallocation of risks and profit potential is likely to also be followed in Finland.

As was the case in Russia, tax authorities may under Finnish law also challenge the allocation of risks, if the legal form of the arrangement does not correspond to the real intention of the matter. The contractual terms may be disregarded, for example, on the basis of § 28 of the AAP. It is noteworthy that it has been regarded likely in the legal literature that the tax authorities may be willing to interfere in the allocation of risks especially in business restructurings, if they are not satisfied with the allocation, by referring to the anti-avoidance principles and provisions, such as the aforesaid § 28 of the AAP.<sup>516</sup> Hence, Finnish law is in line with both Russian law and the OECD Transfer Pricing Guidelines from this perspective.<sup>517</sup>

Taking into account the above-mentioned observations, it appears that no justification can be found for the view that transfers of risks and associated profit potential could be transferred alone in business restructurings and consequently could fall within the scope of application of the Finnish transfer pricing rules as separate items. Nevertheless, transfers of risks must be taken into consideration, when an arm's length compensation is determined for transfers of assets/something of value or for termination/renewal of existing agreements occurred in a business restructuring, as the allocation of risks must be examined and taken into account in the functional and comparability analyses under Finnish law. In this sense, the Finnish transfer pricing rules follow the OECD Transfer Pricing Guidelines closely, which also means that the earlier discussed provisions of Chapter I and Chapter IX, which

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<sup>514</sup> OECD Transfer Pricing Guidelines, 1.72.

<sup>515</sup> Finnish Tax Administration: Statement A177/200/2015.

<sup>516</sup> Juusela – Tuominen 2011, p. 317.

<sup>517</sup> It must be noted that the Finnish transfer pricing provision, § 31 of the AAP, cannot be interpreted in a way which would allow to disregard the legal form of related party transactions, but the provision only gives the tax authorities the right to make transfer pricing adjustments. Tax authorities must apply § 28 of the AAP, which is a special anti-avoidance provision, if they are willing to contest the form or characterization of a transaction. More on this topic, see Section 5.5 of this study.

contain more specific guidance in terms of risk analysis as well as risk and profit potential reallocation, should primarily be applied in Finland too. In addition, no major differences can be found between Finnish and Russian law in this respect.

The U.S. transfer pricing rules also lack regulations regarding whether transfers of risks (and associated profit potential) could alone fall within Section 482 of the IRC and whether they should be consequently compensated at arm's length as separate items. Whether risks could be regarded as intangible property for transfer pricing purposes in the USA could first be examined. Risks — as well as profit potential — are not listed in the IRC's provisions and the Treasury Regulations as intangible properties, which could fall within the scope of application of the U.S. transfer pricing rules.<sup>518</sup> It seems unlikely that they could also be regarded as "other similar items" to those listed in Section 936(h)(3)(B) of the IRC and the related Treasury Regulations and in this way could be treated as intangible property for the purposes of Section 482. No legal support for such a view can be found from case law nor legal literature. Quite the contrary, in the legal literature, it has been viewed that that a transfer of risks does not constitute an asset that should be remunerated, for instance, in the form of an exit tax during a business restructuring.<sup>519</sup> More importantly, the IRS itself does not consider risks as property or something of value. Pursuant to the Internal Revenue Manual, "risk is a position that will yield an outcome that is not known at the time the position is taken. Risk therefore entails exposure to the possibility of loss. If a company takes on more risk, it will have a greater expectation of profit."<sup>520</sup> In addition, in the legal literature, it has been argued that no remuneration should be paid alone for transfers of risks.<sup>521</sup> Furthermore, it must be noted that profit potential, which is usually transferred in conjunction with risks, has not been regarded as an

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<sup>518</sup> See Section 936(h)(3)(B) and Treas. Reg. § 1.482-4(b).

<sup>519</sup> Zollo 2011, p. 775.

<sup>520</sup> Section 4.61.3.5.3 of the Internal Revenue Manual.

<sup>521</sup> Zollo 2011, p. 767. However, Zollo also theoretically argues that in certain exceptional cases the arm's length principle could require that transfer of risks should be compensated: if the expected profits of a transferor of risks do not decrease commensurate with the reduction of transferred risks, a compensation might be required to be paid to the transferee. In such a scenario, Zollo does not nevertheless imply that solely a transfer of risks would result in compensation, and it seems that even in such a scenario risks should be transferred in connection with a business or assets, which affect the future profits of the transferor. In addition, usually transfers of risks have a corresponding impact on the future profits of a transferor, and therefore situations where the expected profits are not in line with the reduction of risks, seem to be purely theoretical, or otherwise there might be a risk that such transfers of risks do not conform to their real substance.

asset in the Treasury Regulations, but more like a feature of an asset, which leads to that it cannot be transferred separately from assets.<sup>522</sup>

Hence, risks and profit potential cannot be treated as assets or another separable item in the above-mentioned manner. As the transfer pricing rules are primarily applicable to identifiable (intangible) assets, it seems unlikely that they could be applied to transactions involving solely transfers of risks and/or profit potential. On the other hand, it also appears that risks and profit potential can principally be transferred only along with other property/something of value. These observations support the view that transfers of risks and profit potential cannot fall within the scope of application of the U.S. transfer pricing regulations at least as own separate items in related party transactions. As a result, it seems that transfers of risks and related profit potential may not be objects of transfer pricing separately, also in business restructurings.

Nevertheless, the Treasury Regulations have not completely overlooked the relevance of risks in the transfer pricing context. According to the Treasury Regulations,

“determining the degree of comparability between controlled and uncontrolled transactions requires a comparison of the *significant risks* that could affect the prices that would be charged or paid, or the profit that would be earned, in the two transactions.”<sup>523</sup>

The risks thus affect the pricing of related party transactions in the above-discussed manner. The risk analysis should be conducted as a part of the comparability analysis for the purposes of comparing the results of a controlled transaction to the results of transactions between independent parties under similar circumstances,<sup>524</sup> which eventually has an impact on the determination of an arm’s length compensation in the controlled transaction in question. The Treasury Regulations mention, among other things, market, financial, credit and product liability risks as relevant risks to consider, when controlled and uncontrolled transactions are compared.<sup>525</sup> As discussed earlier, the risk analysis is technically separated from the functional analysis, as both form their own parts of the comparability analysis.

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<sup>522</sup> See e.g. Treas. Reg. § 1.482-4(c)(2)(iii)(B)(1).

<sup>523</sup> Treas. Reg. § 1.482-1(d)(3)(iii)(A).

<sup>524</sup> Treas. Reg. § 1.482-1(d)(1). This is a general regulation concerning risk analysis as part of the comparability analysis. Economic risks have also been regarded as factors to be considered in determining the comparability of transactions involving transfers of intangibles, see Treas. Reg. § 1.482-4(c)(2)(iii)(B)(2).

<sup>525</sup> Treas. Reg. § 1.482-1(d)(3)(iii)(A)(1)–(6).

The profit potential that is associated with risks may affect the pricing of a related party transaction through a comparability analysis. For example, pursuant to the Treasury Regulations regarding transfer pricing of intangibles, when a related party applies a comparable uncontrolled transaction method in order to determine the arm's length compensation for a transfer of intangible property, one comparability factor — when the controlled transaction and ultimately the pricing thereof is compared to uncontrolled transactions — is the profit potential of the intangible property in question.<sup>526</sup>

In the business restructuring context, the above mentioned means that risks, as well as profit potential, must be taken into account, when the comparability analysis is performed for the related party transactions occurring during a business restructuring, if such transactions involve transfers of assets/something of value subject to transfer pricing pursuant to the U.S. transfer pricing rules. Thus, the risk allocation in such transactions must also be taken into consideration in the determination of the comparability of controlled and uncontrolled transactions and consequently in the determination of the arm's length compensation for transfers of assets/something of value.

Furthermore, the Treasury Regulations have paid special attention to the identification of the related party that bears the risks in a given case. As a general rule, the controlled party that bears the risks in a related party transaction is determined on the basis of contractual terms. However, pursuant to the regulations, “the allocation of risks specified or implied by the taxpayer's contractual terms will generally be respected if it is *consistent with the economic substance of the transaction*. An allocation of risk between controlled taxpayers after the outcome of such risk is known or reasonably knowable lacks economic substance.”<sup>527</sup> Thus, the above mentioned means

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<sup>526</sup> Treas. Reg. § 1.482-4(c)(2)(iii)(B)(1).

<sup>527</sup> Treas. Reg. § 1.482-1(d)(3)(iii)(B). The factors with regard to examining the economic substance have been regulated in Treas. Reg. § 1.482-1(d)(3)(iii)(B) in more detail:

“In considering the economic substance of the transaction, the following facts are relevant:

- (1) Whether the pattern of the controlled taxpayer's conduct over time is consistent with the purported allocation of risk between the controlled taxpayers; or where the pattern is changed, whether the relevant contractual arrangements have been modified accordingly;
- (2) Whether a controlled taxpayer has the financial capacity to fund losses that might be expected to occur as the result of the assumption of a risk, or whether, at arm's

that the IRS may disregard the allocation of risks, if it does not conform to the economic substance of the transaction. This is naturally also applicable to transactions conducted in the course of a business restructuring. In the legal literature, the examination of the economic substance of transactions in accordance with the Treasury Regulations has been considered of particular importance in business restructurings, as it helps to determine how the allocation of risks between related parties has changed in the business restructuring — or has it changed at all.<sup>528</sup> As the U.S. transfer pricing rules expressly recognize the possibility that the tax authorities may intervene in the allocation of risks between related parties by relying on the anti-avoidance principles, U.S. law conforms to Russian and Finnish law as well as to the OECD Transfer Pricing Guidelines to a great degree in this respect.

Overall, it can be stated that the risk allocation between related parties must be examined in a business restructuring primarily for the purposes of determining the arm's length compensations for transfers of something of value that has occurred in the restructuring that are subject to transfer pricing pursuant to law; transfers of risks and associated profit potential may not fall within the scope of application of the U.S. transfer pricing provisions as separate items. In this regard, U.S. law is in line with the Russian and Finnish transfer pricing provisions. On the other hand, the risks should be analyzed principally as part of the comparability analysis under the specific risk analysis regulations, and in this way U.S. law slightly deviates from Russian and Finnish law, where the assumed risks are reviewed as part of the functional analysis. Despite this small, rather technical difference, it seems to be equally important in Russia, Finland and the USA to analyze the allocation of risks between related parties in business restructurings. Such an analysis is conducted for the purpose of determining, through functional and/or comparability analyses, the comparability of controlled and uncontrolled transactions and eventually the arm's length compensations for transfers of assets/something of value subject to transfer pricing pursuant to the national regulations.<sup>529</sup>

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length, another party to the controlled transaction would ultimately suffer the consequences of such losses; and

- (3) The extent to which each controlled taxpayer exercises managerial or operational control over the business activities that directly influence the amount of income or loss realized. In arm's length dealings, parties ordinarily bear a greater share of those risks over which they have relatively more control."

<sup>528</sup> Amerkhail – Granwell 2009, p. 405.

<sup>529</sup> It has also been acknowledged in the legal literature that the U.S. rules and the OECD Transfer Pricing Guidelines approach the risk analysis similarly. Under both sources of law, similar risks, such as market

If the contractual or other allocation of risks does not conform to the reality in business restructurings, the laws of Russia, Finland and the USA (as well as the OECD Transfer Pricing Guidelines) allow the interference by the tax authorities in transactions conducted in the course of a business restructuring in the above-discussed manner. Therefore, it is essential for companies to pay attention to the risk allocation and to prepare required transfer pricing documentation diligently, showing, among other things, the grounds for the allocation of risks between the related parties in detail. In such a way, the likelihood of potential disagreements with tax authorities may be reduced.

The existing approach taken by the target countries seems to meet the requirements of the arm's length principle efficiently. Risks and profit potential clearly lack the ability of being transferred alone, and in this sense it is also unlikely that independent parties could transfer risks alone, separately from other assets. On the other hand, when risks and associated profit potential are transferred together with assets and functions, they must be taken into account as one factor affecting the pricing of such transfers — or at least their possible effects must be considered. As dealt with above, the assumption of risks and overall increase/decrease of risks would likely be taken into account in the compensation of transactions conducted between independent parties.<sup>530</sup> As related parties should consider the allocation of risks and compare the circumstances of the given related party transaction, inter alia, in terms of assumed risks to transactions conducted between independent parties in comparable circumstances, related parties and independent parties are treated similarly from this perspective.

### **3.8 TERMINATION OR RENEGOTIATION OF EXISTING AGREEMENTS**

A cross-border business restructuring may involve the termination or substantial renegotiation of existing arrangements and agreements of the restructured company. For instance, when a company transfers a part of its sales activities to another group company, the existing licensing and distribution agreements between the parties may no longer be needed. If such agreements are being terminated prematurely or contractual rights are violated by other means, the restructured company may suffer detriments. In

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risks and financial risks, must be taken into consideration, and also the actual conduct of the parties and the control over the business linked to risks in question are deciding factors in determining which party bears the risks; see Wright – Keates 2009, p. 117 and PwC 2015, pp. 1086–1087, where the latter has more of an informative nature.

<sup>530</sup> See e.g. OECD Transfer Pricing Guidelines, 1.60, 1.100.



that case, the question of whether it may become necessary to pay an arm's length compensation for such financial loss or detriments suffered by the company becomes topical.<sup>531</sup>

As was the case with the transfers of risks, the termination or renegotiation of existing agreements or arrangements of a company may be a problematic question in Russia from the transfer pricing perspective. The Tax Code's transfer pricing provisions do not deal with the termination or renegotiation of existing agreements — or compensation thereof — at all.<sup>532</sup> Since the legislation traditionally plays a pivotal role in Russian law, the lack of legal norms in this respect causes ambiguity and speaks more for the view that terminations or renegotiations of existing agreements may not become objects of the Russian transfer pricing rules.

In addition, indemnifications or other compensations paid for detriments suffered by the restructured company are not listed in Article 1225 of the Civil Code, and therefore may not be considered as intellectual property protected under Russian law. Consequently, they cannot fall within the scope of application of the Russian transfer pricing regulations in accordance with the aforementioned Minfin's written clarifications and the FTS's letter either from this perspective. It has also been stated in the legal literature that premature terminations or renegotiations of contracts cannot *per se* result in tax consequences.<sup>533</sup>

When taking into account the above-mentioned, it is very unlikely that the questions with regard to terminations and/or renegotiations of existing agreements should be taken into consideration in transfer pricing of cross-border business restructurings under Russian law, although a compensation for the detriments caused by the premature termination or renegotiation of a contract would under similar conditions be paid in transactions between independent companies. Tax practitioners have also viewed that, due to the fact that Russian law and the interpretation of legal questions in Russia are substantially based on legislated legal norms, the premature termination or renegotiation of agreements could be in the scope of transfer pricing only, if the Tax Code had corresponding provisions. Moreover, given that the Supreme Commercial Court and the Minfin have not clarified the existing legal situation in this regard, the practitioners have not applied transfer pricing provisions to premature terminations or renegotiations of existing agreements in their

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<sup>531</sup> De Robertis – Matthias – Damian 2006, p. 18; OECD Transfer Pricing Guidelines, 9.75.

<sup>532</sup> Cf. Article 58 of the Civil Code, which has general provisions regarding the allocation of liabilities between parties in the context of mergers and acquisitions.

<sup>533</sup> Evdokimov – Konnov 2011, p. 633.

transfer pricing practices.<sup>534</sup> Thus, on these grounds, it seems that the termination or renegotiation of existing agreements in the course of business restructurings do not fall within the scope of current transfer pricing regulations in Russia.

Nevertheless, it should be noted that it has been considered in the Russian legal literature that the termination or renegotiation of existing agreements could be subject to taxation, if it concerns a remission of debt.<sup>535</sup> In addition, the Minfin has issued written clarifications according to which *loans and loan interests* granted by related companies to each other are within the scope of the transfer pricing regulations in Russia, despite the fact that this has not been directly regulated in the Tax Code's transfer pricing provisions.<sup>536</sup> Hence, in theory, the termination or renegotiation of existing agreements could fall within the scope of Russian transfer pricing regulations, if the termination or renegotiation could be regarded as a remission of debt or loan.

This view is, however, rather problematic and far-fetched. First, it is very unclear to what extent *debts* are forgiven by related companies in the course of business restructurings in general. It is more likely that the agreements, which are usually amended or terminated prematurely during the restructurings, concern different aspects of multinational enterprise's business activities, such as sales, marketing and manufacturing activities. These kinds of agreements cannot be regarded as loan agreements. When such agreements are prematurely renegotiated or terminated, it is also a question of the loss of the expected income under such agreements rather than debt forgiveness. When taking into consideration that also tax advisors are of the opinion that the premature termination or renegotiation of existing agreements cannot be an object of the Russian transfer pricing regulations in any form,<sup>537</sup> it is justified to state that the premature termination or renegotiation of existing agreements may not fall within the scope of application of the Russian transfer pricing rules also from this perspective.

Taxpayers should nonetheless be extremely careful, if they decide to terminate existing agreements, or renegotiate them substantially, in Russia during business restructurings. Since the transfer pricing provisions do not seem to be applicable to the terminations of existing agreements directly, the Russian tax authorities may be willing to intervene in the premature terminations or

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<sup>534</sup> Expert Interview 2012.

<sup>535</sup> Evdokimov – Konnov 2011, p. 633.

<sup>536</sup> Raz'yasneniya Ministerstva Finansov Rossijskoj Federatsii po voprosam primeneniya razdela V.I Nalogovogo kodeksa Rossijskoj Federatsii; Pis'mo Ministerstva finansov Rossijskoj Federatsii ot 05.07.2012 N 03-01-18/5-92 "Po voprosu primeneniya otdel'nykh polozhenij razd. V.1 NK RF."

<sup>537</sup> Expert Interview 2012.

renegotiations of contracts by questioning transactions' legal forms and by seeking to prove that taxpayers have achieved unjustified tax benefit in their arrangements.<sup>538</sup> This kind of tax authorities' intention to interfere in transactions in Russia is always a potential risk, which should be taken into account, if legal provisions do not specifically authorize the authorities to intervene in arrangements.<sup>539</sup> Therefore, it is inevitable to pay specific attention to the arguments and documentation used to validate the business restructuring, especially in cases where the termination of existing agreements is necessary for the effective execution of the business restructuring.

The current situation in Russia can be criticized from the perspective of the arm's length principle. If independent parties would be entitled to a remuneration in comparable situations, the principle would require as a starting point that such a compensation should be paid also for the premature termination of agreements between related parties. As mentioned above, that seems unlikely in light of the existing provisions. Conversely, general legal provisions, which regulate certain business activities, may not necessarily require that a compensation should be paid for the termination or renegotiation of agreements of such activity. For instance, although the Civil Code regulates the agency activity in detail in Articles 1005–1011 of the Civil Code, no requirements are set for the compensation or remuneration of terminations of agency arrangements. Nonetheless, this does not indicate that independent parties would not compensate such terminations, as such matters are likely to be agreed on in the contractual terms of agency agreements. Thus, the more important question is whether independent parties would include an indemnification clause for the termination of an agreement, and on what terms, in comparable circumstances. As the existing Russian transfer pricing rules and other sources do not require such an analysis from related parties, the arm's length principle is not followed effectively in this context. Therefore, there is a need for new regulations to meet the requirements of the arm's length principle in this particular transfer pricing question.

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<sup>538</sup> By relying on anti-avoidance regulations and principles, such as sham transaction under 170 of the Civil Code and the principle of unjustified tax benefit introduced in the Supreme Commercial Court's decision *Postanovlenie Plenuma Vysshego Arbitrazhnogo suda Rossijskoj Federatsii ot 12 oktyabrya 2006 goda N 53 "Ob otsenke arbitrazhnymi sudami obosnovannosti polucheniya nalogoplatel'shnikov nalogovoj vygody."* See Section 5.5 of this study for a more detailed analysis.

<sup>539</sup> This can especially be seen in the case law regarding the former transfer pricing rules, where the tax authorities used various grounds for justifying their interventions in companies' transfer pricing. The tax authorities' resolutions, however, were often amended in favor of taxpayers by the Supreme Commercial Court; see e.g. *Postanovlenie FAS Zapadno-Sibirskogo okruga ot 28.08.2007 N F04-5904/2006(37326-A27-31) po delu N A27-43916/2005-2.*

The legal situation in Russia differs in this regard from the standpoint of the OECD. According to the OECD Transfer Pricing Guidelines, the applicability of the arm's length principle must also be considered in situations where an existing contractual relationship is terminated or substantially renegotiated during a business restructuring. This means that, inter alia, the following three conditions must be taken into account when assessing whether an indemnification would be warranted at arm's length in situations where existing agreements are terminated or substantially renegotiated:

- "Whether commercial law supports rights to indemnification for the restructured entity under the facts of the case as accurately delineated ---";
- "Whether the existence or absence of an indemnification clause or similar provisions (as well as the terms of such a clause where it exists) under the terms of the arrangement, as accurately delineated, is arm's length ---"; and
- "Which party should ultimately bear the costs related to the indemnification of the party that suffers from the termination or renegotiation of the agreement. ---"<sup>540</sup>

Also in Finland, the termination or renegotiation of existing agreements has been left without attention in the legislated transfer pricing provisions. Notwithstanding that there are no express mentions of terminations or renegotiations of existing agreements or arrangements, according to the preliminary works, it should be taken as a starting point that § 31 of the AAP should be applied to all kinds of transactions, which can be regarded as commercial actions performed in business and other commercial activities.<sup>541</sup> As the definition of transactions subject to transfer pricing is in this sense broad, terminations of business agreements — even existing fixed-time contracts — could be deemed to fall within the scope of application of § 31 of the AAP, as such actions cannot be considered that unusual in everyday business life and especially in business restructurings.

Support for such a view can be found from the Finnish Tax Administration's memorandum dealing with the transfer pricing documentation. Pursuant to the memorandum, functional analysis must contain, among other things, a description of the changes in the related parties' functions, which may have occurred in the course of business restructurings. Such changes may have been executed by making amendment to the existing contracts/contractual terms or by concluding new agreements.<sup>542</sup> Therefore, as the Finnish Tax

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<sup>540</sup> OECD Transfer Pricing Guidelines, 9.79.

<sup>541</sup> HE 107/2006 vp, p. 20.

<sup>542</sup> Finnish Tax Administration Memorandum 1471/37/2007, pp. 25–26.

Administration acknowledges the possibility that agreements may be renegotiated specifically in the business restructuring context and requires that such amendments are documented in the functional analysis, changes in the existing contractual arrangements — including the terminations of business agreements — must be taken into consideration in the transfer pricing analysis of business restructurings pursuant to Finnish law.

In addition, this view has also been shared in the legal literature. It has been considered likely that a compensation at arm's length should be paid for transfers of existing arrangements in business restructurings, although no legal provisions or decision practice can be found to validate such a compensation payment. This can be justified, *inter alia*, by the fact that generally a selling party should be remunerated for transfers of existing contractual arrangements in transactions conducted between independent parties.<sup>543</sup>

Taking into account the above-mentioned observations, there should not be legal reasons for disregarding terminations or renegotiations of existing agreements in the transfer pricing analysis of a business restructuring under the Finnish transfer pricing provisions. In practice, this means that related parties should examine in business restructurings, on a case-by-case basis, whether independent parties would compensate certain terminations or renegotiations of existing agreements in similar conditions. If a remuneration would be paid between independent parties in such cases, that indicates that the termination or renegotiation of the arrangement in question will likely fall within the scope of application of the Finnish transfer pricing rules and must be remunerated appropriately at arm's length between related parties. As Finnish law conforms to the approach taken by the OECD, and when also taking into account that no specific provisions can be found in the Finnish transfer pricing provisions in terms of examining the applicability of the arm's length principle to the terminations/renegotiations of existing agreements, the more detailed OECD Transfer Pricing Guidelines should be followed in this respect in Finland.

Pursuant to the OECD Transfer Pricing Guidelines, there should be no assumption according to which all terminations or substantial renegotiations of existing agreements should be compensated at arm's length.<sup>544</sup> As stated above, three different factors must be taken into account, when determining whether an arm's length compensation shall be paid in a given case.<sup>545</sup>

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<sup>543</sup> Juusela – Tuominen 2011, pp. 319–320.

<sup>544</sup> OECD Transfer Pricing Guidelines, 9.78.

<sup>545</sup> OECD Transfer Pricing Guidelines, 9.79.

First, it must be reviewed in business restructurings whether commercial law, i.e. applicable national legislation or case law, would require that the termination or renegotiation of an existing agreement would be compensated, even though such a remuneration should not be paid pursuant to the agreement in question.<sup>546</sup> In Finland, the above mentioned must be taken into consideration especially in long-term agreements.<sup>547</sup> Pursuant to Finnish contract law, long-term agreements expire either when the agreement is terminated or when a fixed term has ended. A long-term agreement, which is in nature a fixed-term agreement, cannot thus be terminated before the expiry of the term. On the other hand, agreements in force until further notice may be terminated after a certain period of notice. If a long-term agreement is terminated unlawfully, a party to the agreement is usually entitled to a compensation.<sup>548</sup> Thus, in order to comply with the arm's length principle, such a compensation should also be paid at arm's length in business restructurings, if unrelated parties would be entitled to it pursuant to law in comparable situations.

In addition, for instance, the Finnish Act on Commercial Representatives and Salesmen (417/1992, *laki kauppaedustajista ja myyntimiehistä*) may require that unlawful terminations of agreements relating to sales activities are compensated, which must be taken into consideration especially in business restructurings, where a multinational enterprise's sales activities are amended.<sup>549</sup>

Second, whether the contractual terms and the existence or non-existence of an indemnification clause can be deemed to be arm's length must also be analyzed. As a starting point, it should be reviewed whether the agreement, which is terminated or substantially renegotiated, has been concluded in a written form and includes an indemnification clause, pursuant to which a compensation must be paid. If the termination or renegotiation clauses of the agreement in question — and particularly the indemnification clause — have been followed, there should be no need for additional compensations, provided that such clauses are arm's length. On the other hand, if the related parties have ignored the contractual terms, it must be examined, among other things, whether it has been done in the interest of both parties. Otherwise, this could result in that a compensation for such actions should be paid purely for

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<sup>546</sup> OECD Transfer Pricing Guidelines, 9.80.

<sup>547</sup> Long-term agreements are commonly used in business activities between companies, and they are usually in force for a longer period than, on the contrary, agreements based on non-recurring performance. The latter agreements are used, for instance, in the sale of goods, and they expire on the delivery of such items. See more about the difference in Hemmo 2003, pp. 33–34.

<sup>548</sup> Norros 2009, pp. 633–634, 644.

<sup>549</sup> See § 23, § 26 and § 28 of the Act on Commercial Representatives and Salesmen.

the reason that independent parties could demand such a compensation in similar situations.<sup>550</sup>

After examining the existence or absence of an indemnification clause in favor of the restructured group company, it must be reviewed, *inter alia*, whether independent parties would have concluded under similar circumstances an agreement, which comprises (or in the event of absence, does not comprise) an indemnification clause in case of early termination or renegotiation of an arrangement. In particular, it must be reviewed whether the terms and conditions of the indemnification clause, or the absence thereof, is arm's length. If independent parties would have concluded an agreement containing a similar indemnification clause, this will support the fact that such a clause is arm's length. On the contrary, if the clause differs from the terms and conditions that independent parties would have used, any potential profits that would have accrued had the related parties used arm's length terms and conditions should be included in the profits of a related party for tax purposes.<sup>551</sup> For instance, as mentioned above, the general principles of Finnish contract law may require that an unlawful termination of an existing long-term agreement should be remunerated.

Third, the analysis of whether the terms and conditions of the termination or renegotiation of an existing agreement is arm's length should also cover the examination of which controlled party should ultimately bear the costs with regard to the indemnification of the suffering party for such termination or renegotiation. In that case, the viewpoints of both the transferor and the transferee should be taken into account. For example, a manufacturer could be willing to bear the indemnification costs at arm's length in a situation where it terminates an existing manufacturing agreement with a group company in order to save on future manufacturing costs through a new manufacturing contract with another group company. Thus, under certain circumstances the manufacturing company or another group company taking over the manufacturing activity may be willing to bear the indemnification costs at arm's length.<sup>552</sup> The Finnish Tax Administration has shared this view and nowadays requires an analysis of all potential related parties benefiting from the business restructuring. This may mean, *inter alia*, controlled parties that benefit from investments made by the suffering company during the term of the terminated/renegotiated agreement.<sup>553</sup>

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<sup>550</sup> OECD Transfer Pricing Guidelines, 9.79, 9.81–9.82

<sup>551</sup> OECD Transfer Pricing Guidelines, 9.83–9.92.

<sup>552</sup> OECD Transfer Pricing Guidelines, 9.93–9.97.

<sup>553</sup> Finnish Tax Administration: Transfer Pricing in Business Restructurings.

Pursuant to the OECD Transfer Pricing Guidelines, the termination or renegotiation of existing agreements in a business restructuring may occur in conjunction with transfers of something of value, such as intangibles. In that case, the particular guidance as to transfers of something of value (e.g. tangible or intangible assets) must be applied to such transfers, and the provisions regulating the indemnification for the termination or substantial renegotiation of existing agreements should be taken into consideration, when deciding whether further remuneration should be warranted for any possible detriments arising out of the termination or renegotiation of the existing agreements.<sup>554</sup>

A major difference thus exists between the Finnish and the Russian transfer pricing rules in terms of the treatment of the terminations/renegotiations of existing agreements between related parties. The terminations or renegotiations of agreements and arrangements in business restructurings should be determined under Finnish law on a case-by-case basis. It is also very likely that an arm's length compensation should be paid for such terminations/renegotiations, at least in some cases, while in Russia they are left outside the scope of application of the Tax Code's transfer pricing rules entirely. In this sense, the requirements of the arm's length principle (i.e. the equal treatment of related and independent parties in terms of taxation) are met effectively in Finland in this particular question, especially when taxpayers must in the discussed manner always ultimately review whether independent parties would be entitled to a remuneration pursuant to an indemnification clause (and on what terms) in comparable situations. As previously mentioned, the existing situation in Russia does not allow such a review, and the arm's length principle is thus not followed in this respect. As the OECD's guidance comprising the aforementioned principles is followed in practice already as such in Finland, similar needs to update *de lege ferenda* the prevailing legislation do not exist as in Russia.

On the other hand, in one respect, laws of Russia and Finland conform to each other. It has been considered likely in both countries that tax authorities may be willing to intervene in arrangements, which result in the termination or renegotiation of existing agreements. For instance, in the Finnish legal literature, it has been viewed that the tax authorities may be eager to interfere in such arrangements expressly in the business restructuring context, although related parties may in general prevent such interventions by presenting sound business reasons for the terminations or amendments.<sup>555</sup>

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<sup>554</sup> OECD Transfer Pricing Guidelines, 9.77.

<sup>555</sup> Juusela – Tuominen 2011, p. 320.



The transfer pricing aspects of terminations or renegotiations of existing agreements have not been regulated as such in the U.S. transfer pricing sources either. As the scope of application of the U.S. transfer pricing provisions has been generally left open, such terminations and/or renegotiations should be in the first place reviewed from the perspective of the arm's length standard: if the results of the controlled transaction — in this case, terminations or renegotiations of existing arrangements — are in line with the results that would have been realized in a transaction between independent parties under the same circumstances, the controlled transaction meets the requirements of the arm's length standard.<sup>556</sup>

The examination of the applicability of Section 482 of the IRC to terminations or renegotiations of existing agreements should be started from the identification of the contractual terms in question. It must be first observed that, pursuant to the Treasury Regulations, the IRS may disregard contractual arrangements between controlled parties if the terms of the arrangements are inconsistent with the economic substance of the arrangements. When the economic substance is evaluated, "greatest weight will be given to the actual conduct of the parties and their respective legal rights."<sup>557</sup> Among other things, expressly the terms with regard to the termination and renegotiation rights of parties shall be reviewed in this connection.<sup>558</sup> Therefore, if related parties do not act in accordance with the termination or renegotiation clauses of existing agreements, the IRS may purely on the basis of the discussed Treasury Regulations intervene in such contractual arrangements in business restructurings.

When the contractual terms of an existing arrangement between related parties have been identified in the above-mentioned manner, it must be analyzed whether such terms are arm's length. Thus, if independent parties in the same industry would include in their agreements an indemnification/termination clause according to which (premature) terminations or renegotiations of the existing agreement should be compensated, such a clause should also be incorporated into an agreement between related parties. If a compensation for the termination or renegotiation of an existing arrangement is not paid in accordance with such a clause or if the clause is entirely missing, the IRS may require that the suffered party is entitled to a compensation at arm's length.<sup>559</sup> On the other

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<sup>556</sup> See Treas. Reg. § 1.482-1(b)(1).

<sup>557</sup> Treas. Reg. § 1.482-1(d)(3)(ii)(B)(1). If there is no written agreement between the parties, the IRS "may impute a contractual agreement between the controlled taxpayers consistent with the economic substance of the transaction"; see in detail in Treas. Reg. § 1.482-1(d)(3)(ii)(B)(2).

<sup>558</sup> Treas. Reg. § 1.482-1(d)(3)(ii)(A)(5).

<sup>559</sup> Amerkhail – Granwell 2009, pp. 417–418.

hand, if the agreement between related parties has been terminated pursuant to the terms and conditions of the agreement (i.e. the agreement has expired or the requirements of a written notice has been followed), no additional remuneration is generally required.<sup>560</sup>

For example, usually U.S. distribution agreements contain a term of one year. If a distribution agreement is terminated in accordance with the one year's notice in the course of a business restructuring, the agreement expires and the distributor is not entitled to a remuneration. However, if the distribution agreement is terminated immediately contrary to the termination clause, the distributor is usually entitled to a remuneration in the amount of foregone profits of one year pursuant to the termination and/or indemnification clauses of the agreement.<sup>561</sup> If similar arrangements are terminated between related parties in the business restructuring context in comparable circumstances, it is likely that an appropriate indemnification in accordance with the industrial practices should also be paid to the suffered related party. Ultimately, this means that even in situations where related parties have complied with the indemnification clause of a certain agreement and paid a compensation for a premature termination of the agreement, the remuneration may not be considered arm's length, if independent parties would have included an indemnification clause in their agreement entitling to a higher compensation in similar circumstances.

On the other hand, it may also be possible that a compensation must be paid for a premature termination or renegotiation of an existing agreement on the basis of certain provisions of law. One of the acts, which covers questions as to terminations of agreements in commercial activities, at least to some extent, is the Uniform Commercial Code. The Uniform Commercial Code regulates generally commercial transactions, and it has been adopted by all states in some form.<sup>562</sup> Pursuant to the Uniform Commercial Code, "where the contract provides for successive performances but is indefinite in duration it is valid for a reasonable time but unless otherwise agreed may be terminated at any time by either party." More importantly, "termination of a contract by one party except on the happening of an agreed event requires that reasonable notification be received by the other party and an agreement dispensing with notification is invalid if its operation would be unconscionable."<sup>563</sup> The aforementioned provisions are somewhat vague and concern particularly dealings with goods, but nevertheless provide basic contractual principles, which can be used to validate claims for civil damages in situations where

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<sup>560</sup> Wright – Keates 2009, p. 116.

<sup>561</sup> Zollo 2011, p. 771; Wright – Keates 2009, pp. 115–116.

<sup>562</sup> Zollo 2011, pp. 771–772.

<sup>563</sup> Article 2-309 of the Uniform Commercial Code (2002).

existing agreements have been terminated unlawfully, i.e. without reasonable notification. This is due to the fact that the Uniform Commercial Code also contains provisions on remedies, which entitle the suffered party to damages for breach of contract.<sup>564</sup> If independent parties could achieve remuneration by invoking these provisions, it may be required in business restructurings that a related party is also correspondingly compensated at arm's length under similar circumstances on the basis of these provisions.

Another, perhaps even more important act, which provides specific guidance as regards compensating premature terminations of agreements, is the Restatement (Second) of Contracts (1981). The Restatement deals with the concept of *the expectation interest*, which basically means that suffered party should be put into as good position as the party would be had the agreement been performed. The concept has also been discussed in the legal literature and, more importantly, broadly recognized by the courts.<sup>565</sup> Although the Restatement is not generally a legally binding source in U.S. law or enacted by states in their legislation, it has a persuasive authority, and therefore it is followed to a large extent by courts in their decision-making. Courts also have cited to it in their rulings as if they would have cited to legal statutes or codes.<sup>566</sup> According to the Restatement, expectation interest is a promisee's "interest in having the benefit of his bargain by being put in as good a position as he would have been in had the contract been performed,"<sup>567</sup> and that "the injured party has a right to damages based on his expectation interest."<sup>568</sup> These provisions should be followed in the business restructuring context, if they would be applied under similar conditions to comparable transactions between independent parties. In the end, this means that an appropriate arm's length compensation should be paid in such situations to the suffered related party for the premature termination of an existing agreement.

It has been viewed in the U.S. legal literature that commercial relationships have not been regulated in the USA as extensively as in Europe. Therefore, whether a remuneration should be paid for the termination of an existing commercial agreement, such as distributorship agreement, shall be more often examined from the contractual terms of the specific agreement itself in the

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<sup>564</sup> Articles 2-703 and 2-711 of the Uniform Commercial Code (2002).

<sup>565</sup> See e.g. Landgraf – Arnautovic 2015, pp. 321–322; Tongish v. Thomas, 840 P.2d 471 (Kan. 1992); Metro. Prop. & Cas. v. Harper, 168 Or. App. 358 (2000).

<sup>566</sup> Gutman 2014, p. 118; Klass 2010, p. 46; Maggs 1998, p. 8. In a few U.S. jurisdictions, it is also binding law unless other sources of law do not contradict its provisions. This is the case, for example, in the Virgin Islands; see Maggs 1998, p. 29.

<sup>567</sup> § 344 of the Restatement (Second) of Contracts (1981).

<sup>568</sup> § 347 of the Restatement (Second) of Contracts (1981).

above-mentioned manner.<sup>569</sup> It is true that the European legislation may cover some questions relating to terminations of contractual arrangements more extensively than U.S. law. This can especially be seen from the aforesaid Finnish Act on Commercial Representatives and Salesmen, which regulates in detail how commercial agents should be compensated for unlawful terminations of agency contracts. The act is based on an EU directive,<sup>570</sup> which in turn provides useful help in determining whether a compensation must be paid for terminations or renegotiations of existing agreements in cross-border business restructurings also in other EU member states. On the contrary, there does not exist federal legislation in the USA regulating indemnification rights of sales agents in case of terminations.<sup>571</sup>

That being said, U.S. law nevertheless conforms to a great degree to the OECD Transfer Pricing Guidelines and Finnish law in terms of the transfer pricing treatment of terminations and renegotiations of existing agreements. The termination or renegotiation of an existing arrangement must primarily be examined from the perspective of whether independent parties would have required a compensation for such a termination or renegotiation under similar circumstances, taking into account, among other things, contractual terms used by independent parties in such business activities as well as specific national legislation and case law providing indemnification rights in such situations. The question must be reviewed on a case-by-case basis, and therefore there should be no assumption that the terminations or renegotiations will always be compensated.

In this sense, related and independent parties are treated in a similar manner (i.e. the same amount in subject to income taxation), resulting in that the arm's length principle is followed effectively in this particular question both in the USA and in Finland. Quite the contrary, as Russian law does not in the above-mentioned manner recognize the possibility of applying the transfer pricing regulations to terminations or renegotiations of existing arrangements at all, no arm's length compensation is required for such terminations or renegotiations. Hence, the current Russian approach is troublesome from the perspective of the arm's length principle and therefore a need for amendments to the legislation *de lege ferenda* in this respect clearly exists in Russia, as opposed to the existing situation in Finland and the USA.

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<sup>569</sup> Amerkhail – Granwell 2009, p. 417.

<sup>570</sup> See Council Directive 86/653/EEC of 18 December 1986 on the coordination of the laws of the member states relating to self-employed commercial agents.

<sup>571</sup> In addition, only few states have exceptionally regulated the rights of sales representatives; see Wise 2010, pp. 4–5.

## 3.9 CONCLUSION

### 3.9.1 CURRENT SITUATION AND *DE LEGE FERENDA* VIEWS ON RUSSIAN, FINNISH AND U.S. TAX LAW

In conclusion, it can be stated that there currently exists ambiguity in Russian tax law in terms of the applicability of the transfer pricing rules to certain objects of transfer pricing at least in three aspects. First, the prevailing tax law provisions do not recognize the possibility of regarding business restructurings as transfers of a going concern in situations where a functioning and economically integrated business unit is transferred within the group. Second, the transfer pricing rules have not expressly dealt with transfers of intangibles and, in particular, whether such transfers are subject to transfer pricing. Third, the Tax Code's provisions also remain silent as regards whether an arm's length compensation should be paid for premature terminations or renegotiations of existing agreements. Thus, the Tax Code's provisions cause interpretive problems in business restructurings especially in this regard.

As discussed earlier, the interpretation of Russian law and overall judicial discretion under it are basically based only on written legal norms. From this perspective, it may be extremely difficult to find justification for a view according to which assets and functions transferred in the course of a business restructuring would not be identified and valued separately, but on an aggregate basis, if no support can be found for such a view in the Tax Code. The same applies to transfers of intangibles in general as well as to the premature terminations or negotiations of agreements occurring in the course of business restructurings. Moreover, other acceptable — although not binding — sources of Russian law have not dealt with these questions either. For instance, the highest courts, which have achieved a strengthened position in recent years resulting in that their decisions could be in practice legally binding to a certain degree, have not interpreted the new transfer pricing rules in this respect. Also, the Minfin's or the FTS's clarifications and other administrative guidance have been more of technical nature.

Fortunately, one particular question, which is also of relevance in the business restructuring context, constitutes an exception to the above mentioned. Due to the previously discussed Minfin's written clarifications and the FTS's letter, controlled transfers of intellectual properties should be considered to fall within the scope of the Russian transfer pricing rules. This view is justified, regardless of that such guidance is not legally binding but rather informative and clarifying by nature, as no conflicting interpretations have been published on the question by Russian courts or other relevant sources. Also, it is reasonable for taxpayers to follow the guidance in this regard to avoid potential disputes with the tax authorities. Lastly, transfers of intellectual

properties clearly have value that would be compensated had such transfers occurred between independent parties, and therefore the approach can also be validated from the perspective of the arm's length principle. As similar legal support cannot be found for transfers of other intangibles and transfers of a going concern (which may include intangibles), they fall outside the scope of the transfer pricing rules in business restructurings.

The existing situation in Russia is open to criticism. As a result of the narrow scope of application of the transfer pricing rules and the lack of clarifying interpretations of legally binding nature in this respect, only transfers of tangible property and intellectual properties seem to fall within the scope of the transfer pricing rules in the business restructuring context. This leads to transfers of other assets of commercial value as well as premature terminations or renegotiations of agreements falling outside the scope of the Russian transfer pricing rules and ultimately not having to be compensated at arm's length. This is problematic, when taking into consideration that it is self-evident that also transfers of other type of intangibles than intellectual properties are usually remunerated in transactions between independent parties; intellectual properties are not the only intangibles that have commercial value. Therefore, it is unclear, why the Minfin and the FTS have only dealt with the applicability of the transfer pricing rules to controlled transfers of intellectual properties and not to intangible assets in general.

Moreover, premature terminations or renegotiations of agreements may be in some situations compensated between independent parties, which at present is not reflected in the current transfer pricing provisions. Furthermore, the lack of legal support for treating transfers of a going concern on an aggregate basis for transfer pricing purposes is troublesome; it is likely that, for instance in business acquisitions, independent parties would analyze and remunerate simultaneous transfers of assets and functions as a whole. The traditional approach based on separate valuations of transferred items, which should also be applied to transfers of a functioning business unit pursuant to the Russian transfer pricing rules, does not take into consideration all the peculiarities involved in transfers of a going concern, and therefore the end result may deviate largely from that of transfers between independent parties in comparable circumstances.

Consequently, the purpose of the arm's length principle, which should be the guiding principle behind the national transfer pricing provisions also in Russia, is not realized effectively in business restructurings. As the above-discussed transaction types are not subject to transfer pricing, related parties and unrelated parties are not in the end treated equally for tax purposes, as related parties do not have to use arm's length compensations and other commercial terms in their transactions. In addition, it is problematic that such an essential question as the applicability of the transfer pricing rules to

transfers of intellectual property has also been disregarded in the Tax Code's transfer pricing provisions entirely and is subject to interpretation. As the interpretation of Russian law should primarily be based on legal norms, such a relevant issue should also be dealt with directly in the Tax Code's provisions.

Hence, in this regard, it would be important *de lege ferenda* to revise/update the prevailing transfer pricing provisions and other applicable regulations in Russia to be in line with the aims of the arm's length principle, i.e. to include the possibility to consider transfers of intangibles and a going concern as well as premature terminations or renegotiations of existing agreement as objects of transfer pricing, if they would be compensated in transactions between independent parties in comparable situations. In addition, it would be of great importance also to determine in the legislation, how the concept of intangible property should be understood in the transfer pricing context. This could be implemented, for instance, by defining the concept specifically for transfer pricing and/or tax purposes in the Tax Code's provisions. As the Civil Code regulates only legally protected intellectual properties, and no general definition of intangible asset is provided therein, no references can be made to the Civil Code for the purpose of defining the concept of intangible property in the transfer pricing context. On the other hand, as the existing transfer pricing provisions have not dealt with the concept of intellectual property either, it could be possible to refer to the Civil Code's concept of intellectual property in this connection, as it covers in the aforementioned sense typical intellectual properties.

In comparison with Russian tax law, the aforementioned issues are less problematic under Finnish tax law. Correspondingly, such interpretive problems with respect to the scope of application of the transfer pricing rules do not, at least on a large scale, arise in Finland. The differences between the current situation in Russia and Finland could primarily be explained by referring to differences in the legal orders and the hierarchy of sources of law as well as to the relevance of the OECD's guidance as a legal source in the countries. Regardless of that the Finnish provisions of law concerning transfer pricing remain silent in terms of objects of transfer pricing, the preliminary works of the AAP and the decisions of the Supreme Administrative Court, which are also important sources of tax law in Finland, have provided guidance in this respect, which should be followed by taxpayers. More importantly, the significance of the OECD Transfer Pricing Guidelines (including any future updates and revisions) in the interpretation of the national transfer pricing provisions has been confirmed by the said sources. Therefore, as Finland in practice follows the OECD's guidance to a great extent in the interpretation of the arm's length principle, the principles set out, inter alia, in Chapters VI and IX of the OECD Transfer Pricing Guidelines should be applied to business restructurings pursuant to Finnish law.

The above mentioned results in that, apart from transfers of tangible assets, transfers of intangibles, in general, fall within the scope of the transfer pricing rules in Finland. Such intangibles may be intellectual properties, goodwill and even intangibles that are not specifically legally protected but have commercial value that would be compensated between unrelated parties. Similarly, the premature terminations or renegotiations of existing agreements may, depending on the circumstances of the case, be subject to transfer pricing (i.e. must be compensated at arm's length). As Chapter IX of the OECD Guidelines is in the aforementioned manner largely followed in practice, it must also be reviewed in business restructurings whether the restructuring in question should be considered as a transfer of a going concern for transfer pricing purposes, if it involves contemporaneous transfers of interrelated assets. As the OECD Transfer Pricing Guidelines do not have a similar legal status in Russia, its guidance cannot be used as extensively in the interpretation of the arm's length principle and the national transfer pricing provisions as in Finland.

In consequence, as the Finnish transfer pricing rules are applied to transfers of such assets/something of value that are commonly transferred in business restructurings, the arm's length principle is in this sense, to a great extent, efficiently followed in business restructurings in Finland. If independent parties would compensate certain transfers of assets or would remunerate the premature terminations of agreements in comparable circumstances, such transfers or terminations are also subject to transfer pricing in business restructurings between related parties and should ultimately be compensated at arm's length.

In one respect, improvements to the compliance with the arm's length principle could, however, be considered in Finland. Although intangible assets generally fall within the scope of the Finnish transfer pricing rules, the broad concept of intangible property in transfer pricing is not entirely clear and straightforward as stated above. Consequently, the question of to what extent intangibles fall within the scope of the transfer pricing rules in business restructurings may cause interpretive problems in cases where it is not self-evident whether certain items or assets should be regarded as intangible assets and should thus be taken into account in the transfer pricing analysis of a business restructuring. As this kind of vagueness is against the aim of the arm's length principle, it might need to be considered whether such ambiguity should be addressed either in the national sources of transfer pricing or under the OECD's guidance to improve the certainty of the transfer pricing treatment of such (intangible) items. However, as, in the current situation, the determination of all asset types falling within the scope of the concept of intangible assets is likely impossible, the existing Finnish (and thus OECD) transfer pricing rules are largely efficient in terms of the arm's length principle in the above-mentioned manner. In order to improve the compliance with the



arm's length principle, the current rules could be amended *de lege ferenda* to address the aforementioned ambiguous situations. This should, however, be done only, if the sort of measures for this could be found, which do not unnecessarily limit the scope of the concept of intangible assets.

The existing legal situation in the USA conforms largely to the situation in Finland. However, in contrast to the Finnish OECD-based approach, the interpretation of the arm's length principle in the USA is greatly based on the detailed national transfer pricing provisions regulated in the Treasury Regulations. In this respect, U.S law also provides a remarkably broad legal framework for the analysis of transfer pricing aspects of business restructurings, as opposed to Russian law. Pursuant to the regulations, transfers of tangible and intangible assets generally fall within the scope of the transfer pricing rules and are therefore subject to the arm's length compensation. Also, the aggregation of related party transactions is allowed in accordance with the Treasury Regulations, resulting in that business restructurings may be regarded as transfers of a going concern for transfer pricing purposes. In addition, although the transfer pricing aspects of terminations or renegotiations of existing agreements have not been regulated explicitly in the U.S. transfer pricing sources, the Treasury Regulations contain provisions that support in the aforesaid manner the view that terminations and/or renegotiations should be reviewed from the perspective of the arm's length standard.

Nonetheless, as in Finland, U.S. law still leaves certain matters subject to interpretation, when it comes to transfer pricing of intangibles. The decision on whether some intangibles may fall within the scope of the transfer pricing rules should ultimately be done in the USA on a case-by-case basis, taking into consideration whether independent parties would compensate transfers of such non-physical assets in comparable circumstances (either as separate items or as part of complex of assets). This approach can be justified by referring to "other similar items" regulated in the Treasury Regulations concerning transfer pricing of intangibles. However, the concept of "other similar items" may prove to be troublesome in certain cases, as can be seen above from the question with respect to transfer pricing of goodwill and going concern value.

Although the above-mentioned approach (examination of whether independent parties would compensate transfers of such intangible assets) can be applied in the aforesaid manner in the USA to a great extent, it cannot currently be applied unconditionally, mainly due to the fact that *Veritas* has not been yet overruled. Therefore, there is a need to make clarifying amendments to the existing law in terms of transfers of goodwill and going concern value. In addition, as was the case in Finland, in order to improve the compliance with the aims of the arm's length principle, it should be considered

whether the current rules could be amended *de lege ferenda* to address the aforementioned ambiguous situations where it is unclear, whether certain items/assets should be regarded as intangible properties for transfer pricing purposes. However, this should be done only, if the sort of measures for this could be found, which do not unnecessarily limit the scope of the concept of intangible assets. As discussed, the existing transfer pricing rules are otherwise largely efficient in terms of the arm's length principle.

### **3.9.2 ANALYSIS FROM THE PERSPECTIVE OF THE ARM'S LENGTH PRINCIPLE**

The aforementioned legal comparative analysis of the current situations in Russia, Finland and the USA highlights the importance of the possibility of treating business restructurings as transfers of a going concern for transfer pricing purposes in order to comply with the arm's length principle in business restructurings. If a business restructuring can be regarded and treated as a transfer of a going concern under domestic transfer pricing rules in situations where a functioning business unit is transferred, the arm's length result may more likely be achieved and, consequently, the domestic transfer pricing rules be considered consistent with the arm's length principle. If domestic transfer pricing rules do not recognize such a possibility at all, it is not certain whether the arm's length principle is efficiently followed, i.e. business restructurings may not necessarily fall within the scope of the national transfer pricing rules and be thus subject to the arm's length principle to the extent required.

As discussed, the advantage of regarding business restructurings as transfers of a going concern is that there is no need to examine separately, which of the transferring assets/something of value fall within the scope of national transfer pricing regulations in the business restructuring, and which do not. Instead of determining an arm's length compensation for each asset transfer, only one transfer price shall be determined for the transferred business unit. This transfer price, usually based on the future earnings stream of the transferred business, shall cover the transfers of all of the assets and something of value related to the transferred business unit.<sup>572</sup> This means, in practice, that the challenges in relation to determining the extent to which business restructurings should fall within the scope of the national transfer pricing rules (and be thus subject to the arm's length principle) in a given case may, at least to a great extent, be avoided. More importantly, it is likely that the end result is consistent with the arm's length principle, as independent parties would likely analyze and remunerate simultaneous transfers of assets

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<sup>572</sup> See e.g. OECD Transfer Pricing Guidelines, 9.68–9.69.

and functions as a whole in similar situations, like business acquisitions.<sup>573</sup> Hence, the domestic transfer pricing rules may more likely be considered compatible with the arm's length principle, if the possibility to regard business restructurings as transfers of a going concern is included therein.

On the contrary, the examination of controlled transactions on an asset-by-asset or a transaction-by-transaction basis may be more problematic from the point of view of the arm's length principle, if a business restructuring involves a transfer of a functioning business unit (a going concern). First, if such a transfer would be analyzed on an asset-by-asset basis, all transfers of something of value should be compensated, if independent parties would compensate such transfers in their transactions in comparable situations. In practice, this would require that all the items that could have such value should be identified in a business restructuring, which alone may be a difficult task.

Second, some assets or items of commercial value cannot be separated from other assets by their nature. For instance, it is generally viewed in the legal literature that a company's goodwill cannot be transferred separately. The transfer of goodwill usually requires that a whole business unit is transferred simultaneously. Even then, it is very likely that it cannot be identified and distinguished from the other transferred assets.<sup>574</sup> An approach based on an asset-by-asset analysis would thus disregard the transfer of a goodwill, although it has commercial value that would likely be compensated in transactions between independent parties.

Third, even if all the transfers of assets and something of value could in a given case be identified and separated from each other, the arm's length result may not necessarily be achieved. As mentioned above, transfer of a going concern is usually valued on the basis of future income streams. The aggregate sum of separately valued assets, risks and/or functions transferred in the course of a business restructuring may not necessarily amount to the sum that independent parties would determine in comparable transfers of a going concern.<sup>575</sup> Hence, the approach based on separate examinations and valuations of transferred assets and something of value does not take into consideration all the peculiarities involved in transfers of a going concern, and therefore the end result may deviate largely from what independent parties would have ended up with in comparable circumstances. Ultimately, domestic transfer pricing rules can be deemed to be inconsistent with the arm's length principle.

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<sup>573</sup> See e.g. Jaakkola et al. 2012, pp. 313–321; Breen 2014, p. 1483; Cordova – Mitra – Newman – Reams – Shanda – Shapiro 2012, p. 56; Femia – Blair 2008, p. 199.

<sup>574</sup> Cordova – Mitra – Newman – Reams – Shanda – Shapiro 2012, p. 47.

<sup>575</sup> See *supra* notes 571, 572 and 573.

In consequence, the possibility to consider business restructurings as transfers of a going concern must primarily be regulated in domestic legislation or similar sources of legally binding character for the purpose of ensuring the compliance with the arm's length principle. However, it is not sufficient that the possibility thereto alone is regulated. Also, the circumstances in which business restructurings may and should be regarded as a going concern should be regulated in a clear manner.

As mentioned, specific domestic legislation rarely regulates such a possibility.<sup>576</sup> In some countries, like Finland, the OECD Transfer Pricing Guidelines may in practice be used as the guiding source in the interpretation of the arm's length principle regulated in the domestic transfer pricing legislation. Therefore, it may be sufficient that a clear and direct reference to the applicability of the OECD's guidance in this respect is made in the applicable domestic legal sources. However, the circumstances in which a related company should choose the examination of a transfer of a going concern on an aggregate basis, instead of analyzing transfers occurring in a business restructuring on an asset-by-asset basis, could be regulated more clearly in the guidelines, if domestic sources solely rely on the guidelines' guidance in this respect.<sup>577</sup>

Alternatively, it may be sufficient that domestic transfer pricing rules allow the aggregation of related party transactions to the extent that also transfers of a going concern may be examined in business restructurings on an aggregate basis. This kind of approach has been taken by the U.S. Treasury Regulations. Regardless of not directly dealing with transfers of a going concern or referring to the OECD Transfer Pricing Guidelines in this respect, the Treasury Regulations allow the IRS and taxpayers to analyze two or more economically interrelated transactions as a whole for transfer pricing purposes in order to achieve the most reliable arm's length result.<sup>578</sup> Although the question is thus subject to interpretation, the regulations are detailed enough to come to such a conclusion.

A more problematic question, from the perspective of the arm's length principle, arises when a business restructuring involves only transfers of specific assets/something of value, which do not constitute together a functioning business unit (a going concern). In such situations, all transfers of assets and/or something of value occurring in the course of a business

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<sup>576</sup> As discussed earlier, Germany is one of the few countries that is often mentioned as an example in this regard. See *supra* notes 11, 47 and 250.

<sup>577</sup> This question will be discussed in more detail in the next chapter.

<sup>578</sup> Treas. Reg. § 1.482-1T(f)(2)(i)(C).

restructuring should primarily be identified and valued separately, on a transaction-by-transaction basis. This means in practice that such assets/something of value should also be regulated as objects of transfer pricing pursuant to the national transfer pricing rules. While the question of whether transfers of tangible assets should fall within the scope of transfer pricing rules and be subject to the arm's length principle is usually clear, particularly, the question in relation to transfers of intangible assets is more troublesome.

As primarily intangible assets — such as intellectual properties — clearly have commercial value that would be compensated in transactions between independent parties, the arm's length principle, as a starting point, requires that their transfers should fall within the scope of application of the domestic transfer pricing rules. If domestic transfer pricing rules regulate the transaction types that are in the scope of application of the transfer pricing rules, the above mentioned means that transfers of intangibles should be included in the transaction types falling within the scope. As the current situation in Russia clearly shows, if the regulated scope of application of the domestic transfer pricing rules is narrow and clarifying interpretations of legally binding nature lack in this respect, the domestic rules can, perhaps unintentionally, leave such assets out of the scope of transfer pricing rules. In consequence, such transfer pricing rules should be considered inconsistent with the arm's length principle.

The concept of intangible property is broad. Therefore, it is a difficult, or even impossible, task to explicitly identify and list separately all intangible assets that should be subject to the arm's length principle in the scope of domestic transfer pricing rules. As discussed, not all intangibles are protected by national regulations and/or recorded on a company's balance sheet. Moreover, certain intangibles, such as goodwill and going concern value, cannot necessarily be defined in a precise and clear manner. From the perspective of the arm's length principle, the decisive factor should always be whether independent parties would compensate transfers of such intangible property in similar conditions. This results in that the inability to define or list all intangibles in transfer pricing regulations as asset types falling within the scope of transfer pricing rules must not lead to certain intangibles falling outside the scope of transfer pricing rules (and, consequently, not being subject to the arm's length principle).

Based on the examination of the approaches of Russian, Finnish and U.S. law, the best solution to tackle potential problems seems to be to regulate the applicability of transfer pricing rules to intangibles generally and to have a broad definition of intangible asset in transfer pricing rules and/or other related sources that clarify the content of the primary sources. In that case, it may be reasonable, from the perspective of the arm's length principle, to leave

a definition of intangible asset open for transfer pricing purposes and not to aim at exhaustively determining all the intangible asset types falling within the scope of the concept. When applying such an approach, the decision on whether some intangibles fall within the scope of the transfer pricing rules in business restructurings should be made ultimately on a case-by-case basis, taking into consideration *whether independent parties would compensate transfers of such non-physical assets in comparable circumstances*. This kind of analysis brings a taxpayer closer to an arm's length result in comparison with situations where the intangible assets subject to transfer pricing would be listed in the national transfer pricing rules exhaustively — as it is unlikely that the concept of intangible can be defined to cover all possible intangible assets that may have commercial value.

Depending on how the aforementioned approach is adopted in practice, one alternative may be preferable over another. Domestic transfer pricing rules may comprise a non-exhaustive list of specifically mentioned intangibles with a reference to other similar items that should be considered intangible properties for transfer pricing purposes,<sup>579</sup> or the concept of intangible asset may be left entirely open.<sup>580</sup> The first alternative may leave room for ambiguities more than the latter, as in such situations it must be interpreted what such “similar items” may be. As evidenced above, this may be a challenging task in practice. The latter thus brings more likely the best arm's length result, as ultimately, it must be analyzed whether independent parties would compensate transfers of such non-physical assets in comparable circumstances.

Nonetheless, even the approach based on a broad definition of intangible asset for transfer pricing purposes may cause challenges from the perspective of the arm's length principle. As the concept is left open to interpretation, the uncertainty in relation to transfer pricing of intangible assets increases in cases, where it is unclear whether an item should be regarded as an intangible asset at all and, if so, whether a transfer thereof would be compensated in transactions between independent parties. In the worst-case scenario, this may enable both taxpayers and tax authorities to interpret the question of whether an arm's length compensation should be paid for a certain, presumably, non-physical item for their own benefit.<sup>581</sup>

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<sup>579</sup> As is the case in the USA, see Treas. Reg. § 1.482-4(b).

<sup>580</sup> As in Finland, see HE 107/2006 vp, p. 20, Finnish Tax Administration Memorandum 1471/37/2007, pp. 24 and 37, Finnish Tax Administration: Statement A177/200/2015 and OECD Transfer Pricing Guidelines, 6.6 and 6.7.

<sup>581</sup> Similar thoughts have been expressed in e.g. Markham 2015, pp. 686–687.

Nevertheless, simply from the point of view of ensuring that all (valuable) intangible assets fall within the scope of application of transfer pricing rules — and thus, are subject to the arm's length principle — in business restructurings, the approach seem to provide the best possible measure in the current situation. As discussed, it is unlikely that all intangible items having commercial value could be identified in transfer pricing rules. Furthermore, no perfect transfer pricing rules exist, as there is always a need to reflect constantly changing business environment in transfer pricing rules. As the broad concept makes the analysis of such assets on a case-by-case basis (i.e. whether such assets would be compensated in uncontrolled transactions in comparable situations) possible, related parties and independent parties may, in the end, be treated similarly. Also, this approach does not rule out that certain tools or measures to tackle the aforementioned unclear situations could be adopted to such transfer pricing rules that are based on a broad concept of intangible assets.

When transfers of risks and associated profit potential are reviewed in the business restructuring context, consideration of such factors in the functional and/or comparability analyses seems to meet the requirements of the arm's length principle most efficiently. Risks and profit potential clearly lack the ability of being transferred alone, and in this sense it is also unlikely that independent parties could transfer them alone, separately from other assets. On the other hand, when risks and associated profit potential are transferred together with assets and functions, they must be taken into account as one factor affecting the pricing of such transfers — or at least their possible effects must be considered. As dealt with above, the assumption of risks and overall increase/decrease of risks would likely be taken into account in the compensation of transactions conducted between independent parties.<sup>582</sup> As related parties should consider the allocation of risks and compare the circumstances of the given related party transaction, *inter alia*, in terms of assumed risks to transactions conducted between independent parties in comparable circumstances, related parties and independent parties are treated similarly from this perspective.

Lastly, when examining to what extent business restructurings should fall within the scope of transfer pricing rules from the perspective of the arm's length principle, domestic transfer pricing rules should include a possibility to consider whether premature terminations or renegotiations of existing agreements should be compensated at arm's length. As the examination of the question needs to be reviewed on a case-by-case basis, such transfer pricing rules that are narrow and remain totally silent in this respect, as is the case in Russia, are inconsistent with the arm's length principle. On the contrary, the

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<sup>582</sup> See e.g. OECD Transfer Pricing Guidelines, 1.60, 1.100.

Finnish, OECD-based, approach brings good results in terms of the arm's length principle, as the question is discussed in a detailed and coherent manner in the OECD Transfer Pricing Guidelines, and the possibility to analyze the question is not based only on the interpretation of the arm's length standard (as seems to be the case in the USA).

### **3.9.3 OECD TRANSFER PRICING GUIDELINES — A STANDARD TO BE FOLLOWED UNIVERSALLY?**

The OECD Transfer Pricing Guidelines seem to provide, in the aforementioned manner, adequate guidance in relation to the compliance with the arm's length principle when the objects of transfer pricing are discussed in the business restructuring context. Chapter IX of the OECD Transfer Pricing Guidelines contains a detailed presentation of transfers of something of value that should be taken into consideration in the transfer pricing analysis of business restructurings. The OECD Transfer Pricing Guidelines have generally been considered to constitute an international standard in transfer pricing.<sup>583</sup> Hence, should the guidelines, in their present form, be regarded as the guiding international standard also in business restructurings? Furthermore, and more importantly, should they be adopted in a consistent manner to domestic transfer pricing legislation and regulations, when it is reviewed to what extent business restructurings should be subject to the arm's length principle?

As discussed above, the transfer pricing aspects of business restructurings may be analyzed both on an aggregate basis and on a transaction-by-transaction basis. If a business restructuring can be regarded and treated as a transfer of a going concern under domestic transfer pricing rules in situations where a functioning business unit is transferred, the arm's length result may more likely be achieved and, consequently, the domestic transfer pricing rules be considered consistent with the arm's length principle. The OECD Transfer Pricing Guidelines recognize such a possibility, as they regulate transfers of an ongoing concern as one form of transfers (of something of value) subject to the arm's length principle in business restructurings. Pursuant to the guidelines, a transfer of this kind of "a functioning, economically integrated business unit" may be analyzed and valued on an aggregate basis, if it comprises "multiple contemporaneous transfers of interrelated assets, risks, or functions".<sup>584</sup>

Furthermore, the OECD Transfer Pricing Guidelines recognize the possibility of reviewing transfers of something of value — such as tangible assets and intangibles — and potential premature terminations or substantial

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<sup>583</sup> See e.g. Calderón 2007, pp. 4–5.

<sup>584</sup> OECD Transfer Pricing Guidelines, 9.68–9.69.



renegotiations of existing arrangements separately, when objects of transfer pricing are determined in business restructurings.<sup>585</sup> Moreover, also the allocation of risks and profit potential must be taken into account in the transfer pricing analysis of business restructurings, although they are not objects of transfer pricing as such.<sup>586</sup>

As the OECD's guidance covers the typical objects of transfer pricing in business restructurings and enables business restructurings to be regarded as transfers of a going concern for the purpose of achieving the best arm's length result, it is consistent with the arm's length principle. The OECD's guidance, which is largely followed in Finland when the arm's length principle is interpreted in practice, has brought good results in terms of the arm's length principle also in Finland. The extent to which business restructurings fall within the scope of the domestic transfer pricing regulations in Finland is deemed to be in line with the arm's length principle to a great degree. Therefore, could the OECD Transfer Pricing Guidelines be a global transfer pricing solution to business restructurings that could also be adopted to domestic transfer pricing rules?

Although the OECD's concept of business restructuring for transfer pricing purposes is in this sense compatible with the arm's length principle, few observations speak against such a view. First, it can be questioned whether the OECD provides sufficient guidance on conditions on which business restructurings should be regarded as transfers of a going concern for transfer pricing purposes. Although the OECD defines the concept in a definite manner, it does not regulate clearly when the examination of contemporaneous transfers of assets, risks and functions should be analyzed on an aggregate basis. For instance, it mentions that "the determination of the arm's length compensation for a transfer of an ongoing concern *does not necessarily* amount to the sum of the separate valuation" and that "valuation of those [contemporaneous] transfers on an aggregate basis *may be necessary*."<sup>587</sup>

Second, in connection with the above said, the guidelines do not currently take a clear stand on whether the approach based on the examination of contemporaneous transfers of assets/something of value as a whole over the approach based on separate analyses of related party transaction occurring

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<sup>585</sup> See OECD Transfer Pricing Guidelines, 9.48–9.49, 9.55 and 9.75. As mentioned earlier, also "outsourcing" is mentioned as potential transfer of something of value, although the presentation of the question is very limited and no separate compensation as such is likely to be paid; see OECD Transfer Pricing Guidelines, 9.74.

<sup>586</sup> See OECD Transfer Pricing Guidelines, 9.39–9.46.

<sup>587</sup> OECD Transfer Pricing Guidelines, 9.69.

during a business restructuring is preferred.<sup>588</sup> Although the OECD states that the aggregate valuation may be the best option to achieve the arm's length result, no clear and direct position is expressed in the guidelines. The OECD also starts the presentation of transfers of something of value in the guidelines with separate analyses of different kinds of assets that could be transferred in business restructurings, before discussing the possibility of considering business restructuring as a whole, i.e. as transfers of a going concern. Thus, although the examination of a business restructuring as a going concern is possible pursuant to the existing guidance, the arm's length principle in the aforesaid manner usually requires that such an approach is also prioritized in practice, when a functioning business unit is transferred in a business restructuring.

Third, the concept of something of value used by the OECD to define objects of transfer pricing does not include the termination or substantial renegotiation of existing agreements, although they should be taken into consideration in the arm's length analysis of business restructurings.<sup>589</sup> For the sake of clarity and coherency, the question should be regulated under the section dealing with transfers of something of value.

Fourth, the ambiguity that may arise from the broad concept of intangible asset cannot be ignored in this context. As stated, the use of the broad concept of intangible asset in the OECD Transfer Pricing Guidelines makes possible that all such intangible assets that would be compensated in transactions between independent parties should correspondingly fall within the scope of application of domestic transfer pricing rules — and thus be subject to the arm's length principle — in business restructurings. In the current situation, as is it extremely unlikely that all intangible asset types could be defined exhaustively in domestic transfer pricing rules, the mentioned approach brought good results in terms of the arm's length principle in Finland; related parties must in the end analyze on a case-by-case basis whether independent parties would compensate transfers of such items having intangible nature in their transactions.

However, while such an approach seems to be the best option to achieve an arm's length result in the current legal situation in Finland, it is less acceptable to have such unclarity in an international standard that would be followed

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<sup>588</sup> Already the discussion draft of Chapter IX was considered ambiguous in this regard, see e.g. Frotscher – Oestreicher 2009, p. 381.

<sup>589</sup> OECD Transfer Pricing Guidelines, Chapter IX, Sections E and F.

broadly by OECD member states and even by non-member states.<sup>590</sup> As mentioned, as the concept is left open to interpretation, the uncertainty in relation to transfer pricing of intangible assets increases in cases where it is unclear whether an item should be regarded as an intangible asset and, if so, whether a transfer thereof would be compensated in transactions between independent parties. This makes the compliance with the arm's length principle more uncertain and unpredictable — which is against the aim of the principle.

The above-mentioned concerns in relation to the concept of intangible asset have been shared also in the legal literature. The OECD's broad concept of intangibles has been considered to cause uncertainty especially for taxpayers. It has been expressed that a vague interpretation benefits tax authorities, entitling them to interpret the concept for their benefit. Moreover, the risk of double taxation arises, when national authorities try to ensure their share of a multinational enterprise's income.<sup>591</sup>

On the other hand, the OECD's BEPS Project on intangibles has even been considered to ease the tax avoidance, due to the complexity and ambiguity of new rules.<sup>592</sup> This view can be approved, as the new guidance may enable also taxpayers to interpret the questions in relation to transfer pricing of intangibles for their own good. Hence, the broad concept of intangibles introduced by the OECD cannot, in its present form, be used as the guiding standard currently. The question of how to define intangibles in a more concrete manner, covering nevertheless all potential items of value that would be compensated in transactions between independent parties, remains to be answered.<sup>593</sup>

On the basis of the above-discussed observations, in order to regard the OECD Transfer Pricing Guidelines as the guiding international standard that could be adopted to the domestic transfer pricing rules to achieve the best possible arm's length result in this context, aforesaid concerns need to be addressed *de lege ferenda* by introducing amendments and/or updates to the current guidance of the OECD.

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<sup>590</sup> Due to the fact that the guidelines are widely accepted, also countries that are not OECD member states follow to a great extent the guidelines when they enact domestic transfer pricing rules, see Lubic – Gelin – Ossard-Quintaine 2014, pp. 70–71.

<sup>591</sup> Markham 2015, pp. 684, 686–687

<sup>592</sup> T'ng 2016, pp. 422, 433.

<sup>593</sup> See about the discussion in relation to the concept of intangible and possible solutions thereto in Markham 2015, pp. 673–687.

## **4 DETERMINATION OF ARM'S LENGTH COMPENSATION**

### **4.1 ARM'S LENGTH PRINCIPLE AS A STARTING POINT**

When the controlled transactions, which take place in the course of a business restructuring, have been examined, and especially the transfers of assets and/or something of value subject to the national transfer pricing regulations have been identified in the above-discussed manner, the next step is to determine the arm's length compensations for such transfers. Correspondingly, if the business restructuring involves a transfer of a going concern, an arm's length price should be determined for the whole transferred going concern. Business restructurings do not form an exception as regards to the application of the arm's length principle, meaning that the transfer prices must meet the requirements of the arm's length principle/arm's length standard, i.e. conform to the prices used between unrelated parties in comparable transactions under similar circumstances.

The determination of an arm's length compensation is a multi-step process, which involves performing a comparability analysis and the application of an appropriate transfer pricing method. The comparability analysis will be discussed first in the following.

### **4.2 COMPARABILITY ANALYSIS**

As discussed, the comparability analysis in general means the comparison between the terms and conditions of a related party transaction and the terms and conditions of a comparable unrelated party transaction (comparable unrelated party transactions) conducted under similar circumstances. The purpose of the comparability analysis is to demonstrate in particular that the compensation paid in the controlled transaction conforms to the compensations paid between independent parties in comparable transactions and is thus arm's length.<sup>594</sup> The comparability analysis is generally a part of the transfer pricing documentation required by law.<sup>595</sup> The Finnish legislation does not have specific regulations with regard to conducting the comparability analysis, but the preliminary works require that the OECD Transfer Pricing Guidelines must be followed in this regard.<sup>596</sup> The Tax Code's provisions

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<sup>594</sup> See e.g. OECD Transfer Pricing Guidelines, 1.33.

<sup>595</sup> See § 14b of the AAP; Article 105.5 and 105.15 of the Tax Code; Treas. Reg. § 1.6662-6(d)(2)(iii)(B).

<sup>596</sup> HE 107/2006 vp, p. 16.

regarding the comparability analysis correspond to a great degree to the OECD Transfer Pricing Guidelines' provisions, while the U.S. regulations contain also small differences when compared to the guidelines.

In principle, the comparability analysis consists of identifying the conditions and economically relevant circumstances of a related party transaction, after which it must be examined whether such conditions and economically relevant circumstances are in line with the conditions and economically relevant circumstances of comparable transactions between unrelated parties.<sup>597</sup> The controlled and uncontrolled transactions are usually comparable, if there are no such differences between the transactions which could affect the compensation paid in such transactions or there can be made reasonable adjustments to eliminate the effects of possible differences.<sup>598</sup>

Pursuant to the OECD Transfer Pricing Guidelines, the economically relevant factors, which must be taken into account when determining whether such transactions are comparable, include

- "the contractual terms of the transaction;"
- "the functions performed by each of the parties to the transaction, taking into account assets used and risks assumed, including how those functions relate to the wider generation of value by the group to which the parties belong, the circumstances surrounding the transaction, and industry practices;"
- "the characteristics of property transferred or services provided;"
- "the economic circumstances of the parties and of the market in which the parties operate;" and
- "the business strategies pursued by the parties."<sup>599</sup>

The Russian Tax Code's provisions regulating the factors to be taken into consideration in the comparability analysis are fully compatible with the above-mentioned factors.<sup>600</sup> Also, under Finnish law the comparability analysis consists of the same five factors, and the guidance of the OECD Transfer Pricing Guidelines must be followed in this respect.<sup>601</sup> The Treasury Regulations, on the other hand, list expressly risks as one factor and fail to mention the business strategies as factors to be analyzed in determining the

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<sup>597</sup> OECD Transfer Pricing Guidelines, 1.33–1.34.

<sup>598</sup> OECD Transfer Pricing Guidelines, 1.110; Article 105.5 of the Tax Code; Treas. Reg. § 1.482-1(d)(2).

<sup>599</sup> OECD Transfer Pricing Guidelines, 1.36.

<sup>600</sup> Article 105.5 of the Tax Code.

<sup>601</sup> HE 107/2006 vp, p. 16.

comparability of related and unrelated party transactions, while otherwise the listed factors conform to the provisions of the OECD Transfer Pricing Guidelines and the Tax Code.<sup>602</sup> This difference is not of great relevance in practice, as the risks are dealt with in the risk analysis as part of the functional analysis under the OECD Transfer Pricing Guidelines and Russian law,<sup>603</sup> and correspondingly business strategies, such as market share strategy, may also be taken into account in the U.S. transfer pricing as a particular circumstance pursuant to the Treasury Regulations.<sup>604</sup>

The comparability analysis, where the said factors are taken into account, must also be performed in business restructurings in order to determine whether the transactions executed therein are arm's length.<sup>605</sup> Therefore, the group companies must find comparable transactions in order to justify the prices and/or other commercial terms used in the controlled transactions occurred in a business restructuring. In general, such comparable transactions can be internal or external comparable transactions. An *internal comparable* is a comparable transaction conducted previously between one of the controlled parties in question and an independent party, while an *external comparable* is a comparable transaction conducted purely between independent parties.<sup>606</sup> Usually, the use of internal comparables is easier and more reliable in comparison with the external comparables, as the accurate information required for the comparability analysis can be found more effortlessly from the group's records.<sup>607</sup> It is no surprise thus that the internal comparables are preferred over external comparables under Russian, Finnish and U.S. law as well as the OECD Transfer Pricing Guidelines.<sup>608</sup> The information on comparable transactions can be obtained from several different sources, such as commercial databases, group companies' own databases and publicly available sources. It must be noted that such information must be

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<sup>602</sup> Treas. Reg. § 1.482-1(d)(1).

<sup>603</sup> See OECD Transfer Pricing Guidelines, 1.56, 1.60; Article 105.5 of the Tax Code.

<sup>604</sup> Treas. Reg. § 1.482-1(d)(4).

<sup>605</sup> OECD Transfer Pricing Guidelines, 9.13.

<sup>606</sup> See e.g. HE 107/2006 vp, p. 17; OECD Transfer Pricing Guidelines, 3.24; Treas. Reg. § 1.482-3(c)(3)(ii)(A); Treas. Reg. § 1.482-3(d)(3)(ii)(A).

<sup>607</sup> See e.g. Jaakkola et al. 2012, p. 104; HE 107/2006 vp, p. 17; Hellevig – Usov – Kabakov 2014, p. 222; Wittendorff 2010a, p. 397.

<sup>608</sup> See Article 105.6 of the Tax Code; HE 107/2006 vp, p. 17 and Finnish Tax Administration Memorandum 1471/37/2007, p. 32; Treas. Reg. § 1.482-3(c)(3)(ii)(A) and Section 4.61.3.6 of the Internal Revenue Manual; OECD Transfer Pricing Guidelines, 3.27–3.29. Prior to the newest transfer pricing provisions, internal comparables were not allowed at all under Russian tax law; see Informatsionnoe pis'mo Prezidiuma VAS RF ot 17.03.2003 N 71 "Obzor praktiki razresheniya arbitrazhnymi sudami del, svyazannykh s primeneniem otdel'nykh polozhenij chasti pervoj Nalogovogo kodeksa Rossijskoj Federatsii."

transferrable to the tax authorities and cannot thus be confidential in nature.<sup>609</sup>

In the business restructuring context, the above mentioned means that such comparables must also be found for related party transactions occurred in a business restructuring to demonstrate that the prices and/or other commercial terms used in the transactions are consistent with the prices/commercial terms that would have been used had independent parties conducted such transactions. This can be a challenging task, as usually it is difficult — or even impossible — to find comparable business restructuring transactions<sup>610</sup> to validate the compensation paid in a particular business restructuring due to the fact that the circumstances and conditions under which business restructuring are executed vary from case to case. However, at least the following observations can be made.

When a business restructuring involves separate transfers of assets and/or something of value, which will fall within the scope of application of national transfer pricing provisions, but which will not form together a going concern for transfer pricing purposes, the transfer pricing analysis for such transfers will be conducted on a transaction-by-transaction basis. In that case, it will be examined separately in every related party transaction occurred in a business restructuring, whether the commercial terms are in line with comparable transactions between unrelated parties under similar circumstances. Finding comparable transactions for such controlled transactions separately might be an easier task than finding comparables for a transfer of a going concern. For example, it is likely not as troublesome to find comparables for transfers of certain tangible or intangible property as it may be for a transfer of a whole business unit (i.e. going concern).

If the business restructuring involves a transfer of a going concern, it is even questionable whether internal comparables can be used in such situations at all. As cross-border business restructurings are performed between group companies within a multinational enterprise, it may be unlikely that identical or even similar cross-border business restructurings have been conducted

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<sup>609</sup> Finnish Tax Administration Memorandum 1471/37/2007, p. 32; Article 105.6 of the Tax Code. The sources of information, which should be used in conducting a comparability analysis, have been regulated in a comprehensive way in the Tax Code, which can be considered progressive. As one of the most used commercial databases in Russia can be mentioned SPARK (available at [www.spark.interfax.ru](http://www.spark.interfax.ru)). In the USA, for instance, Standard & Poor's or Moody's databases can be used when external comparables are searched for, see Section 4.61.3.6 and Exhibit 4.61.2-6 of the Internal Revenue Manual. Also in Finland, the commercial databases are used in search of comparables; see Finnish Tax Administration Memorandum 1471/37/2007, pp. 32–34.

<sup>610</sup> See e.g. Silberztein 2009, p. 63.

previously in the group taken into account the nature of the restructured business; the industry and market, where the business in question is carried; the combination of assets/something of value, which forms the business unit; and other similar features. The use of external comparables in such situations does not simplify the task either. The information obtained from transactions between independent parties should be detailed enough to assess the comparability between the related party transaction (i.e. business restructuring) and the unrelated party transaction, such as a business acquisition. The more complex the transactions between independent parties are, the more difficult it is to get information about such transactions as an outsider, especially when the detailed information on business acquisitions and similar corporate transactions is in general kept confidential between the attended parties and will not be shared in public.

As under the Russian transfer pricing rules business restructurings may be never treated as transfers of a going concern, the comparison analysis will be performed on a transaction-by-transaction basis even in situations where the transfers of interrelated assets have the ability to perform certain business functions and would thus form a functioning business unit. From this perspective, performing a comparability analysis may be an “easier task” in Russia on some occasions, when compared to Finland and the USA, where business restructurings must be regarded as transfers of a going concern under certain circumstances.

On the other hand, as mentioned above, transfer pricing regulations usually acknowledge that it may be sometimes insurmountably difficult to find comparables for related party transactions. For instance, pursuant to the Treasury Regulations, “because *identical transactions can rarely be located*, whether a transaction produces an arm's length result generally will be determined by reference to the *results of comparable transactions under comparable circumstances*.”<sup>611</sup> In addition, “in order to be considered comparable to a controlled transaction, an uncontrolled transaction *need not be identical* to the controlled transaction, but must be *sufficiently similar* that it provides a reliable measure of an arm's length result. If there are material differences between the controlled and uncontrolled transactions, *adjustments must be made* if the effect of such differences on prices or profits can be ascertained with sufficient accuracy to improve the reliability of the results.”<sup>612</sup> Similar provisions can also be found in the Tax Code and the OECD Transfer Pricing Guidelines.<sup>613</sup> These provisions can be of practical importance especially in Finland and the USA, when identical comparables

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<sup>611</sup> Treas. Reg. § 1.482-1(b)(1).

<sup>612</sup> Treas. Reg. § 1.482-1(d)(2).

<sup>613</sup> See e.g. OECD Transfer Pricing Guidelines, 1.39–1.40, 1.110; Article 105.5 of the Tax Code.



cannot be found for transfers of a going concern or specific intangible assets. If related parties can find similar unrelated party transactions, at least by making reasonable adjustments to eliminate possible material differences between the transactions in the above-mentioned manner, such unrelated party transaction can be used as comparables.

Nevertheless, it may be possible that comparable transactions cannot be found for transfers of a going concern even after making adjustments to the differences between the controlled and potentially comparable transactions. Although comparable uncontrolled transactions cannot be found for a business restructuring, it does not mean that the business restructuring is not arm's length. In such situations, it is useful to follow the OECD's guidance in Chapter I and IX. Pursuant to the OECD Transfer Pricing Guidelines, in determining the arm's length conditions of business restructurings, it is relevant to identify the commercial or financial relations between the related parties by taking the following steps: (i) to accurately delineate the transactions comprising the business restructuring (taking into consideration the functions, assets and risks before and after the business restructuring); (ii) to examine business reasons for and the expected benefits from the restructuring (including the role of synergies); and (iii) to examine other options realistically available to the parties.<sup>614</sup>

The first item was discussed already earlier in the section dealing with the functional analysis, and its basic idea is to "identify the economically significant activities and responsibilities undertaken, assets used or contributed, and risks assumed before and after the restructuring by the parties involved. Accordingly, the analysis focuses on what the parties actually do and the capabilities, as well as the type and nature of assets used or contributed by the parties in a pre-restructuring and post-restructuring scenarios."<sup>615</sup> The second item seeks to understand the business reasons for and the expected benefits from the business restructuring, taking into account in particular the synergies. If there group of companies has anticipated synergies as one of the main reasons for the business restructuring, such synergies may have economic significance in the arm's length analysis.<sup>616</sup> Finally, other options, which may be realistically available to the related parties in the business restructuring, should also be reviewed, as independent parties would generally "compare the transaction to the other options realistically available to them, and they will only enter into the transaction if

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<sup>614</sup> OECD Transfer Pricing Guidelines, 9.14–9.31.

<sup>615</sup> OECD Transfer Pricing Guidelines, 9.18. See also OECD Transfer Pricing Guidelines, 1.37.

<sup>616</sup> OECD Transfer Pricing Guidelines, 9.24.

they see no alternative that offers a clearly more attractive opportunity to meet their commercial objective.”<sup>617</sup>

Due to the general applicability of the OECD Transfer Pricing Guidelines, such provisions can be used as interpretive help in determining whether the business restructuring meets the requirements of the arm’s length principle in Finland, and therefore taxpayers should record the review of such factors accurately in their transfer pricing documentation. Although such an option has not been regulated in the Treasury Regulations explicitly, such factors can also be taken into consideration in U.S. business restructurings to validate the commercial terms used in the business restructuring.<sup>618</sup>

## 4.3 TRANSFER PRICING METHODS AND OTHER VALUATION METHODS

### 4.3.1 GENERAL REMARKS

When related parties have conducted the comparability analysis and have found enough comparables for the controlled transaction(s) performed in the course of a business restructuring, the next step is to determine the arm’s length compensation for the transaction(s) by using the information derived from comparable uncontrolled transactions. The arm’s length result of the controlled transactions will primarily be tested by using specific transfer pricing methods. With transfer pricing methods, the taxpayers are required to demonstrate in the transfer pricing documentation that the determination of the compensation paid in the transaction is consistent with the arm’s length principle. Traditionally, the transfer pricing methods have been divided into *traditional transactional methods* and *profit-based methods*. According to the OECD, traditional transactional methods are the comparable uncontrolled price method, the resale price method and the cost plus method. Transactional profit methods, on the other hand, are the transactional net margin method and the transactional profit split method.<sup>619</sup> These transfer pricing methods

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<sup>617</sup> OECD Transfer Pricing Guidelines, 9.27. See also OECD Transfer Pricing Guidelines, 1.38.

<sup>618</sup> In addition to the first two factors mentioned in the OECD Transfer Pricing Guidelines (review of transactions taking into account functions, risks etc. and business reasons), the Treasury Regulations also specifically regulate that the IRS “may consider the *alternatives available to the taxpayer* in determining whether the terms of the controlled transaction would be acceptable to an uncontrolled taxpayer faced with the same alternatives and operating under comparable circumstances”; see Treas. Reg. § 1.482-1(f)(2)(ii)(A). See also Treas. Reg. § 1.482-7(g)(2)(iii)(A). In this sense, legal support can be found for such a view.

<sup>619</sup> See e.g. OECD Transfer Pricing Guidelines, 2.1.

and other methods used to determine the arm's length compensation as well as the applicability thereof in particular to business restructurings will be discussed in this chapter.

Transfer pricing methods used under Russian tax law are regulated in detail in the Tax Code.<sup>620</sup> It is noteworthy to observe that the Russian provisions concerning the transfer pricing methods are equivalent to the methods regulated in the OECD Transfer Pricing Guidelines, and therefore it is likely that the guidelines can be used as interpretive help in this respect also in Russia.<sup>621</sup> The Finnish transfer pricing provisions do not contain specific regulations in relation to transfer pricing methods, but pursuant to the preliminary works and the Finnish Tax Administration, the transfer pricing methods discussed in the OECD Transfer Pricing Guidelines are applied as such in Finland.<sup>622</sup> The Treasury Regulations comprise, similar to the Russian Tax Code, detailed provisions on the application of transfer pricing methods for the purposes of Section 482 of the IRC.<sup>623</sup>

Selecting a transfer pricing method may be a difficult task in general and especially in business restructurings. Pursuant to the OECD Transfer Pricing Guidelines, *the most appropriate method* must be selected for the determination of an arm's length compensation taken into account, among other things, "the appropriateness of the method considered in view of the nature of the controlled transaction, determined in particular through a functional analysis; the availability of reliable information (in particular on uncontrolled comparables) needed to apply the selected method and/or other methods; and the degree of comparability between controlled and uncontrolled transactions, including the reliability of comparability adjustments that may be needed to eliminate material differences between them."<sup>624</sup> Also, under Russian transfer pricing rules, the starting point is the application of the most appropriate method to the controlled transaction in question.<sup>625</sup> Furthermore, a similar approach has also been taken in the Treasury Regulations under the so-called *best method rule*. Pursuant to the rule, "the arm's length result of a controlled transaction must be determined under the method that, under the facts and circumstances, provides the *most*

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<sup>620</sup> See Articles 105.7 and 105.9–105.13 of the Tax Code.

<sup>621</sup> Kaftannikov is also of the same opinion; see Kaftannikov 2011, p. 31.

<sup>622</sup> HE 107/2006 vp, p. 18; Finnish Tax Administration Memorandum 1471/37/2007, pp. 36–38. Unless otherwise stated, the transfer pricing methods regulated in the OECD Transfer Pricing Guidelines, which will be dealt with in the following sections in more detail, will be applied as such directly to cross-border business restructurings in Finland in the manner to be discussed hereunder.

<sup>623</sup> See e.g. Treas. Reg. § 1.482-3, § 1.482-4, § 1.482-9.

<sup>624</sup> OECD Transfer Pricing Guidelines, 2.2.

<sup>625</sup> Article 105.7 of the Tax Code.

*reliable measure of an arm's length result.*" In such a review, the degree of the comparability between the related party transaction and comparables as well as the quality of the data and assumptions used in the analysis should be taken into consideration.<sup>626</sup>

Regardless of the similar approaches, the OECD Transfer Pricing Guidelines and the Tax Code's provisions deviate from the U.S. transfer pricing rules significantly at least in one respect. Although there does not exist an explicit hierarchy of transfer pricing methods, the former sources prefer traditional transaction methods, and especially the use of the comparable uncontrolled price method (to be discussed below), over profit-based methods.<sup>627</sup> The Treasury Regulations, on the other hand, do not contain such a preference; in contrast, no transfer pricing method will be considered more reliable than other transfer pricing methods.<sup>628</sup> The preference for transactional methods under the OECD Transfer Pricing Guidelines and the Tax Code may lead to that the arm's length results for the similar controlled transactions performed in a business restructuring may be different under the best method regulated in the Treasury Regulations and the corresponding provisions of the OECD Transfer Pricing Guidelines and the Tax Code.

It must also be observed that the Tax Code and the OECD Transfer Pricing Guidelines recognize the possibility of using transfer pricing methods in conjunction with each other in order to reach the best result in terms of the arm's length result,<sup>629</sup> while under the Treasury Regulations other transfer pricing methods can only be taken into account as an additional factor in selecting the transfer pricing method under the best method rule, if they verify the (arm's length) results of the selected and applied transfer pricing method.<sup>630</sup>

Next, the transfer pricing methods applicable to business restructurings are dealt with in more detail. First, it will be examined what kinds of methods could be possibly used, when a business restructuring concerns only transfers of certain tangible/intangible assets or when they are transferred at the same time with other type of assets/something of value but such transfers do not constitute together a going concern for transfer pricing purposes. After that, it

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<sup>626</sup> Treas. Reg. § 1.482-1(c)(1)–(2).

<sup>627</sup> Article 105.7 of the Tax Code; OECD Transfer Pricing Guidelines, 2.3 and 2.15.

<sup>628</sup> Treas. Reg. § 1.482-1(c)(1).

<sup>629</sup> Article 105.7 of the Tax Code; OECD Transfer Pricing Guidelines, 2.12.

<sup>630</sup> See Treas. Reg. § 1.482-1(c)(2)(iii): "If the best method rule does not clearly indicate which method should be selected, an additional factor that may be taken into account in selecting a method is whether any of the competing methods produce results that are consistent with the results obtained from the appropriate application of another method."

will be discussed, which (transfer pricing) methods could be applied to transfers of a going concern as well as to terminations or renegotiations of existing agreements. It should be noted that these methods are just illustrative examples, and the applicability of specific methods is always dependent on the nature and circumstances of the controlled transaction in question.

#### 4.3.2 TANGIBLE ASSETS

When a business restructuring involves transfers of tangible assets, which are not transferred as a part of a functioning business unit (i.e. a going concern), the transfer pricing method will in that case be chosen merely for the transfers of tangible property in question. Pursuant to the Tax Code and the OECD Transfer Pricing Guidelines, *the comparable uncontrolled price method* (hereinafter, the CUP method) is preferred over other transfer pricing methods, and therefore it should be considered as the primary transfer pricing method to transactions involving transfers of tangible assets in business restructurings too.<sup>631</sup> According to the CUP method, the prices used in a related party transaction must conform to the prices used in a comparable uncontrolled transaction under comparable circumstances.<sup>632</sup> The CUP method is understood similarly and regulated as one of the transfer pricing methods applicable to transfers of tangible property also under the U.S. transfer pricing rules, and therefore it can also be used in the U.S. business restructurings, which involve transfers of tangible property.<sup>633</sup>

The importance of finding sufficiently comparable uncontrolled transactions becomes emphasized in the CUP method. There should be no such differences between the related party transaction and comparable unrelated party transactions, which could materially affect the price used in the transactions. Among the economically relevant characteristics to be taken into account in this regard are, for example, the nature and quality of the transferred tangibles as well as the contractual terms.<sup>634</sup> If there are, nevertheless, differences between the controlled transaction and comparable transactions, these differences should not be major in nature, and reasonable adjustments should be made to eliminate the material effects of the differences.<sup>635</sup> In practice, it may be difficult to use the CUP method to validate the prices used in a related

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<sup>631</sup> See Article 105.7 of the Tax Code; OECD Transfer Pricing Guidelines, 2.3.

<sup>632</sup> OECD Transfer Pricing Guidelines, 2.14–2.17; Article 105.9 of the Tax Code.

<sup>633</sup> Treas. Reg. § 1.482-3(b)(1).

<sup>634</sup> OECD Transfer Pricing Guidelines, 2.15–2.22; Article 105.9 of the Tax Code; Treas. Reg. § 1.482-3(b)(2)(ii)(A).

<sup>635</sup> OECD Transfer Pricing Guidelines, 2.14–2.15; Article 105.9 of the Tax Code; Treas. Reg. § 1.482-3(b)(2)(ii)(B).

party transaction, as it may not be an easy task to obtain sufficient information on comparable transactions, for instance, due to the confidentiality of transactions between independent parties or due to geographical reasons.<sup>636</sup> On the other hand, the CUP method may be a reliable method in situations where an independent party sells exactly the same commodities as that are transferred in a related party transaction, and information on such independent party transactions can be obtained.<sup>637</sup>

Hence, the applicability of the CUP method should be first examined in business restructurings in the above-mentioned manner pursuant to Russian and Finnish law. If no comparables cannot be found or reasonable adjustments to potential material differences affecting the price cannot be made, the applicability of other transfer pricing methods should be reviewed. While the Treasury Regulations do not expressly have such a preference for the CUP method, it has been stated that the CUP method may generally provide a more reliable result in term of the arm's length result,<sup>638</sup> which is why the applicability of the CUP method is recommended to be analyzed first also in the U.S. business restructurings. The use of the CUP method has been considered possible, inter alia, in cross-border business restructurings, where raw materials and finished products have been transferred between controlled parties, provided that the conditions of the comparable uncontrolled transactions are comparable to the conditions of the related party transaction occurred in the course of the business restructuring.<sup>639</sup>

*The resale price method* especially can be used in business restructurings, which involve transfers of tangible property in cases, where the tangibles transferred therein will be resold to an independent party after the restructuring. The resale price method is understood similarly in the OECD Transfer Pricing Guidelines, the Russian Tax Code and the U.S. Treasury Regulations. As mentioned above, the method is in general applied to transfers of goods, which will be resold to third parties. Under the method, the compensation paid for the transfer of commodities in a controlled transaction should be the resale price reduced by an appropriate gross margin, or otherwise the compensation is not arm's length. This gross margin covers the expenses of the reseller (selling expenses and other operating expenses) and

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<sup>636</sup> Engblom et al. 2010, p. 532.

<sup>637</sup> Like a certain type of coffee beans, see OECD Transfer Pricing Guidelines, 2.24.

<sup>638</sup> See Treas. Reg. § 1.482-1(c)(2)(i), where it is stated that "an analysis under the comparable uncontrolled price method will generally be more reliable than analyses obtained under other methods if the analysis is based on closely comparable uncontrolled transactions, because such an analysis can be expected to achieve a higher degree of comparability and be susceptible to fewer differences than analyses under other methods."

<sup>639</sup> OECD Transfer Pricing Guidelines, 9.52.

also includes appropriate profit earned by the reseller from the resale of commodities taking into consideration, among other things, the functions performed, assets used and risks assumed in connection with the resale activity.<sup>640</sup>

When determining the arm's length gross margin, it should be first examined what kind of gross margin the reseller has earned on goods, which it has purchased from and sold to independent parties. If such internal comparables cannot be found, it must be reviewed what kind of gross margin is earned by independent resellers in comparable uncontrolled transactions.<sup>641</sup> It must be noted that under Russian law, the resale price method is exceptionally deemed to be the primary transfer pricing method for trading companies, which sell goods to independent companies, if they do not substantially process them before reselling and if they do not own intangibles, which could have a material effect on the pricing of such goods.<sup>642</sup> It has also been stated in the Treasury Regulations and the OECD Transfer Pricing Guidelines that the method is in general used in situations where the related party has not added substantial value to the goods, for instance, by processing or altering the goods before the resale, or where the related party does not use intangible property to add such a substantial value to the goods.<sup>643</sup> Therefore, Russian and U.S. law as well as the OECD Transfer Pricing Guidelines seem to correspond to each other in this sense. The applicability of the resale price method must thus be taken into consideration in these countries especially in the business restructurings where tangible property is transferred to a related party that will in turn resell the tangible property to an independent party after the related party transaction. The resale price method has been regarded possible, for example, in business restructurings, which involve the transfer of finished products, when, among other things, distribution functions have been transferred to a foreign associated party.<sup>644</sup>

Another alternative method to determine the arm's length compensation for transfers of tangible property in cross-border business restructurings is *the cost plus method*. The cost plus method evaluates in particular the supplier's cost of producing tangible assets, which are subsequently transferred to a related party in a controlled transaction. In order to determine an arm's length price for the transfer of tangible assets in the controlled transaction, an

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<sup>640</sup> OECD Transfer Pricing Guidelines, 2.27–2.28; Article 105.10 of the Tax Code; Treas. Reg. § 1.482-3(c)(1)–(3).

<sup>641</sup> OECD Transfer Pricing Guidelines, 2.28; Article 105.10 of the Tax Code; Treas. Reg. § 1.482-3(c)(3)(ii).

<sup>642</sup> Article 105.7 and 105.10 of the Tax Code.

<sup>643</sup> OECD Transfer Pricing Guidelines, 2.35–2.38; Treas. Reg. § 1.482-3(c)(1).

<sup>644</sup> OECD Transfer Pricing Guidelines, 9.52.

appropriate cost plus mark-up is added to this cost. An arm's length compensation thus corresponds to the total amount of the cost of producing the tangible assets in question plus an arm's length mark-up added to the cost. Therefore, the cost plus mark-up of the supplier must conform to cost plus mark-up used on the market by independent parties. As was the case with the CUP method and the resale price method, the cost plus method is regulated to a great degree with the same content under the provisions of the Tax Code, the OECD Transfer Pricing Guidelines and the Treasury Regulations.<sup>645</sup>

Primarily, the cost plus mark-up of the supplier should be in a related party transaction based on the cost plus mark-up earned by the same supplier in comparable transactions with third parties. In addition to internal comparables, the cost plus mark-up earned by independent parties in comparable uncontrolled transactions (external comparables) may be used as help in determining the arm's length price for the related party transaction.<sup>646</sup> As was the case with the resale price method, in order to determine the comparability of the related party and unrelated party transactions, special attention must be paid to the comparability of the functions performed and risks assumed in such transactions as well as to contractual terms.<sup>647</sup> The cost plus method can specifically be used in cases where raw materials, semi-finished products and other goods are transferred after manufacturing activities from a group company to another,<sup>648</sup> and therefore it could be applied especially to business restructurings involving changes in the manufacturing and distribution activities of a multinational enterprise. The cost plus method may be applied in business restructurings, for example, to controlled transfers of inventories, provided that the market value of an inventory is not too low and an arm's length profit may thus be added to the costs.<sup>649</sup>

Nevertheless, in situations where internal comparables cannot be found, the applicability of the method may be troublesome as obtaining information on external comparables may often be difficult due to the sensitive nature of such information. For instance, information on the amount of profit/mark-up

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<sup>645</sup> See Article 105.11 of the Tax Code; OECD Transfer Pricing Guidelines, 2.45; Treas. Reg. § 1.482-3(d)(1)–(2).

<sup>646</sup> Article 105.11 of the Tax Code; OECD Transfer Pricing Guidelines, 2.45–2.46; Treas. Reg. § 1.482-3(d)(3)(ii)(A).

<sup>647</sup> Treas. Reg. § 1.482-3(d)(3)(ii)(A); Article 105.11 of the Tax Code; OECD Transfer Pricing Guidelines, 2.47, 2.50–2.51.

<sup>648</sup> Treas. Reg. § 1.482-3(d)(1); Article 105.11 of the Tax Code; OECD Transfer Pricing Guidelines, 2.45.

<sup>649</sup> OECD Transfer Pricing Guidelines, 9.52.



earned by unrelated companies in similar transactions may not be easily accessible.<sup>650</sup>

As discussed, the aforementioned three transfer pricing methods are considered traditional transactional methods pursuant to the OECD Transfer Pricing Guidelines.<sup>651</sup> It should be noted that, in contrast to Western European countries applying the OECD Transfer Pricing Guidelines, U.S. practitioners do not apply that frequently the resale price method and the cost plus method, as the application of these methods in practice is in general regarded troublesome. This is due to the fact that internal comparables are not often available for the use of the methods, and the use of external comparables is considered challenging and unreliable as all the potential differences must be accounted for.<sup>652</sup> This may have an effect on the use of these methods especially in the U.S. business restructurings, although the same considerations are present also in business restructurings, where the exist country is Russia or Finland.

Also, the so-called profit-based methods can be used in determining the arm's length compensations for transfers of property or services in related party transactions,<sup>653</sup> and therefore it may be appropriate to consider the application of such methods also to transfers of tangible property occurred in the course of business restructurings. The OECD Transfer Pricing Guidelines name as such profit-based methods<sup>654</sup> *the transactional net margin method* and *the transactional profit split method*.<sup>655</sup> These methods are recognized also under the Tax Code and the Treasury Regulations as transfer pricing methods applicable to controlled transactions, although the transactional net margin method is under these sources regulated as the concept of *the comparable profits method*, which also deviates content-wise to some extent from the OECD's corresponding method.<sup>656</sup>

Therefore, the applicability of such profit-based methods must also be examined in business restructuring, when tangible property is transferred in intercompany transactions between related parties. As the profit-based

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<sup>650</sup> Kukkonen – Walden 2010, p. 200.

<sup>651</sup> OECD Transfer Pricing Guidelines, 2.13.

<sup>652</sup> Bronson – Johnson – Sullivan 2014, pp. 24–25.

<sup>653</sup> See e.g. OECD Transfer Pricing Guidelines, 2.4.

<sup>654</sup> The OECD Transfer Pricing Guidelines use the term 'transactional profit methods'.

<sup>655</sup> OECD Transfer Pricing Guidelines, 2.62.

<sup>656</sup> See Article 105.7 and Articles 105.12–105.13 of the Tax Code; Treas. Reg. § 1.482-5 and § 1.482-6. It is noteworthy to mention that the Treasury Regulations expressly state that these methods could also be applied to intercompany transactions involving transfers of tangible property, see Treas. Reg. § 1.482-3(a).

methods may be applied to transfers of *both tangible and intangible assets*, the contents of these methods will be discussed in more detail in the following section, which deals with the transfer pricing methods applicable to transfers of intangible assets.

Nonetheless, in addition to the specified transactional and profit-based transfer pricing methods, the Russian and U.S. transfer pricing rules as well as the OECD Transfer Pricing Guidelines allow related parties to apply also other, unregulated and unspecified methods.<sup>657</sup> The use of unspecified methods can be justified, if they provide the most appropriate and reliable result in terms of the arm's length principle/the arm's length standard. The use of such methods must be validated in the transfer pricing documentation, and they cannot be used in substitution for the above-discussed specified transfer pricing methods regulated in the national transfer pricing rules and the OECD Transfer Pricing Guidelines, if the latter methods could be applied to the related party transaction in question.<sup>658</sup> As in general the transfers of tangible assets in the business restructuring context have not been regarded troublesome,<sup>659</sup> it is likely that at least one of the transactional or profit-based transfer pricing methods provides the most reliable measure of an arm's length result in a business restructuring involving transfers of tangible property, and therefore unspecified methods can most likely be applied only in very exceptional cases.

#### **4.3.3 INTANGIBLE ASSETS: TRANSFER PRICING METHODS**

As discussed earlier, business restructuring may often involve transfers of certain intangible assets. On the other hand, it may also be possible that particular intangible assets are transferred simultaneously with other assets and/or something of value in the course of a business restructuring, but such transfers do not form together a functioning business unit, which could be treated as a going concern for transfer pricing purposes. In such situations, an arm's length compensation must be determined separately on a case-by-case basis for each transfer of intangibles. The intangible assets, which fall within the scope of the national transfer pricing rules, are limited to intellectual properties under Russian law, while the concept of intangible asset must be

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<sup>657</sup> Article 105.7 of the Tax Code and Hellevig – Usov – Kabakov 2014, p. 226; OECD Transfer Pricing Guidelines, 2.9; Treas. Reg. § 1.482-3(e). Under the Tax Code, the determination of an arm's length price by using unspecified methods may be conducted by an independent appraiser.

<sup>658</sup> See e.g. OECD Transfer Pricing Guidelines, 2.9; Treas. Reg. § 1.482-3(e)(1).

<sup>659</sup> See e.g. former paragraph 9.75 of the OECD Transfer Pricing Guidelines. Quite the contrary, the transfer pricing aspects of intangible assets in the business restructuring context have been considered a problematic question, which is of great importance; see e.g. Kroppen – Silva 2011, pp. 38–39.

understood more broadly for transfer pricing purposes under Finnish and U.S. tax law. As the nature and characteristics of intangible properties may vary greatly, no general rule as to the choice of a correct transfer pricing method in situations involving transfers of intangibles can be presented. The unique features of intangibles result in that they also constitute profits and create future benefits differently, which must be acknowledged in performing the comparability analysis and considering the most reliable transfer pricing method in a given situation.<sup>660</sup>

The transactional and profit-based transfer pricing methods regulated in the Tax Code and the OECD Transfer Pricing Guidelines are applied to all kinds of controlled transactions, and therefore they must also be taken as the starting point to controlled transactions involving transfers of intangibles.<sup>661</sup> The Treasury Regulations, on the other hand, regulate specifically the transfer pricing methods applicable to intercompany transactions concerning transfers of intangible property, which thus must be followed also in cross-border business restructurings.<sup>662</sup>

As discussed, the CUP method is preferred over other transfer pricing methods under the Tax Code and the OECD Transfer Pricing Guidelines,<sup>663</sup> which is why its applicability to controlled transactions involving transfers of intangibles must be examined as a starting point in Russia and Finland. Therefore, if reliable information with regard to comparable uncontrolled transactions can be found, the arm's length compensations for transfers of intangibles occurred in the course of a business restructuring should be determined on the basis of these comparables, provided that any material differences affecting the pricing may be adjusted to eliminate potential differences.<sup>664</sup>

The CUP method is applied only to transfers of tangible property under the U.S. transfer pricing rules, but the Treasury Regulations contain a specific transfer pricing method applicable to transfers of intangibles, which is equivalent to the CUP method — the comparable uncontrolled transaction method (the CUT method).<sup>665</sup> The CUT method evaluates whether the amount

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<sup>660</sup> OECD Transfer Pricing Guidelines, 6.116.

<sup>661</sup> See Article 105.7 of the Tax Code; OECD Transfer Pricing Guidelines, 6.131 and 6.136.

<sup>662</sup> See Treas. Reg. § 1.482-4.

<sup>663</sup> Article 105.7 of the Tax Code; OECD Transfer Pricing Guidelines, 2.3, 6.137 and 6.146.

<sup>664</sup> Articles 105.7 and 105.9 of the Tax Code; OECD Transfer Pricing Guidelines, 2.14–2.15, 6.137 and 6.146.

<sup>665</sup> While the priority of the CUT method has not been regulated in the Treasury Regulations explicitly, it is considered the most reliable measure, if sufficient comparables can be found: "If an uncontrolled transaction involves the transfer of the same intangible under the same, or substantially the same,

charged for a transfer of intangible property in a related party transaction is arm's length by comparing it to the amount charged in a comparable uncontrolled transaction. Similar to the CUP method, the amount determined using the CUT method may be adjusted appropriately to address any differences between the transactions.<sup>666</sup> The intangible property shall be deemed to be comparable with the intangible property involved in a related party transaction, if they are used "in connection with similar products or processes within the same general industry or market" and "have similar profit potential."<sup>667</sup>

As stated above, several types of intangible property may fall within the scope of application of the national transfer pricing rules, when they are transferred in cross-border business restructurings as separate items between related parties. Due to the unique characteristics of intangible assets in general, it may be difficult, or even impossible, to find comparable uncontrolled transactions for the controlled intangible asset transaction conducted in a business restructuring. In addition, intangible assets are often of great value for a multinational enterprise in its business activities, and therefore they are more frequently transferred within the group, resulting in that it may be difficult for third parties to obtain information on such transactions because of the confidential nature of such transactions.<sup>668</sup>

Hence, if a business restructuring involves, for example, transfers of trademarks or patents, which were previously used in the distribution or manufacturing activities of the restructured group company, it may prove difficult to use merely external comparables in the determination of the arm's length compensation for such transfers. The possibility of applying the CUP/CUT method to intercompany transfers of intangibles in the business restructuring context is likely restricted to cases, where the same or similar intangibles have been previously transferred within the group between associated parties or between a group company and a third party, i.e. where internal comparables can be found for the said transfers. Also, in the U.S. legal literature, it has been viewed that the required information for calculating the profit potential — which is in the above-mentioned manner one of the comparability factors, when deciding the comparability of the intangibles in question under the Treasury Regulations — may not be usually available for

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circumstances as the controlled transaction, the results derived from applying the comparable uncontrolled transaction method will generally be the most direct and reliable measure of the arm's length result for the controlled transfer of an intangible"; see in Treas. Reg. § 1.482-4(c)(2)(ii).

<sup>666</sup> See Treas. Reg. § 1.482-4(c)(1), § 1.482-4(c)(2)(ii).

<sup>667</sup> Treas. Reg. § 1.482-4(c)(2)(iii)(B)(1).

<sup>668</sup> See e.g. OECD Transfer Pricing Guidelines, 6.138.

companies, unless the company itself or a controlled company within the same group is a party to the comparable uncontrolled transaction.<sup>669</sup>

When the CUP method cannot be applied to the controlled intangible asset transaction, it should be first reviewed whether other transactional transfer pricing methods could be applied to the transaction in accordance with the Russian transfer pricing rules and the OECD Transfer Pricing Guidelines. The CUT method, on the contrary, is the only transaction-based method under the U.S. transfer pricing rules, which may be applied to intangible property transactions,<sup>670</sup> and therefore the resale price method and cost plus method may not be even in theory applied to intangible asset transactions occurred in the business restructuring context. On the other hand, it is very unlikely that these methods could be broadly applied to controlled transactions involving transfers of intangible assets under the Russian and Finnish transfer pricing provisions either.

The resale price method generally requires that the assets involved in a related party transaction are resold to an independent party after the transaction. When a business restructuring involves transfers of intangible assets, such intangibles are usually transferred to another group company for the purpose of practicing certain business activities in future (such as marketing and manufacturing activities) in another jurisdiction, and therefore it is unlikely that the intangible assets would be resold to independent parties after the restructuring in the sense required by the method. In addition, if the intangible assets nevertheless would be resold to third parties, it is uncertain whether the method could provide the most appropriate result in terms of the arm's length principle. For example, the determination of an appropriate gross margin may be difficult especially in cases where the intangibles in question are unique, as it may be hard to find comparables for such intangibles. As a result, the OECD Transfer Pricing Guidelines have even stated that the resale price method is not in general a reliable method for directly valuing intangible assets,<sup>671</sup> leading to that it may not be applied that commonly also to intercompany transfers of intangible assets in business restructurings.

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<sup>669</sup> Markham 2005, p. 96.

<sup>670</sup> See Treas. Reg. § 1.482-3(a), § 1.482-4(a); Markham 2005, p. 95.

<sup>671</sup> OECD Transfer Pricing Guidelines, 6.141. It should be noted that this new paragraph was regulated as part of the BEPS Project. Previously, the OECD Transfer Pricing Guidelines expressly mentioned that the method could be applied to intangible asset transactions, for instance, when a related party sub-licensed the intangible property in question to third parties, see former OECD Transfer Pricing Guidelines, 6.23. In this regard, the guidelines deviated previously from the U.S. Treasury Regulations quite significantly, as the latter do not recognize the possibility of applying the method to transfers of intangibles at all; see more about this in e.g. Markham 2005, p. 100.

It is also ambiguous, how the cost plus method could be applied to controlled intangible asset transactions in general and especially if such transactions have occurred in the business restructuring context. The method requires that an appropriate mark-up is added to the costs of a related party supplier in a controlled transaction. When intangibles are involved in the transaction, it may be difficult to determine such a mark-up especially in cases, where the information about the arm's length mark-ups in comparable uncontrolled transactions cannot be obtained. Chapter IX of the OECD Transfer Pricing Guidelines refers to the method mainly in business restructuring transactions concerning transfers of tangible assets or services.<sup>672</sup> In addition, the newest guidance as to transfer pricing of intangibles in Chapter VI does not discuss the possibility of applying the method purely to the valuation of intangibles in related party transactions, which indicates that it may not be the most reliable method in this respect.<sup>673</sup> Similarly, in the Tax Code and the Russian legal literature the cost plus method has been considered applicable primarily to controlled transactions involving performance of work, provision of services (such as financial transactions) and sale of raw materials/semi-finished products, resulting in that it may not be applied easily to transfers of intellectual properties under the Russian transfer pricing rules either.<sup>674</sup>

Nevertheless, pursuant to the OECD Transfer Pricing Guidelines, the method may be applied to intragroup transfers of intangibles at least on one rare occasion. The guidelines have referred to the applicability of the cost plus method in situations where a group company carries out the contract research for another group company. In that case, the latter company owns the intangibles developed as well as bears the risks of a failure. Pursuant to the guidelines, this is "a typical setup for applying a cost plus method."<sup>675</sup> Therefore, the method may be applied to transfers of intangibles at least theoretically under such circumstances also in business restructurings. However, as the example concerns a provision of services — in the given case, contract R & D activities — the method is more applicable to *post-restructuring transactions* (e.g. transactions conducted in a newly adopted R & D model of a multinational enterprise), not to transactions occurred *in the course of a business restructuring*, which therefore leads to that the method

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<sup>672</sup> OECD Transfer Pricing Guidelines, 9.52. However, it is useful to observe that the cost plus method may be applied to such post-restructuring transactions, where the actual restructuring has involved transfers of trademarks, trade names or other intangibles; see OECD Transfer Pricing Guidelines, 9.123.

<sup>673</sup> See e.g. OECD Transfer Pricing Guidelines, 6.198 and 6.205, where it is discussed that the method may be applied in transactions involving the use of intangibles in connection with the sale of goods or the provisions of services.

<sup>674</sup> Article 105.11 of the Tax Code; Grundel 2014, p. 118.

<sup>675</sup> OECD Transfer Pricing Guidelines, 2.61.

cannot probably be applied that extensively to transfers of intangibles in the business restructuring context that are within the scope of this research.

In addition to the aforementioned transactional transfer pricing methods, the profit-based methods may provide appropriate measures for the determination of arm's length compensations for transfers of intangible assets occurred in a business restructuring. In general, the profit-based methods examine the profits, which arise from the related party transaction in question, and compare them to the profits or the division of the profits in comparable uncontrolled transactions.<sup>676</sup> As the traditional transactional transfer pricing methods, and especially the CUP method, are preferred over the transactional profit methods under the OECD Transfer Pricing Guidelines, the latter methods may be used in Finland basically only when they are found to be more appropriate than the former methods.<sup>677</sup> Similarly, the applicability of the profit-based methods may be reviewed only after examining the applicability of the CUP method to a particular controlled transaction under the Russian transfer pricing rules.<sup>678</sup> While such preferences have not been regulated in the Treasury Regulations expressly, it is acknowledged that in case the sufficient comparables are found, the CUT method is usually the most reliable measure of the arm's length result in controlled transactions involving transfers of intangibles.<sup>679</sup>

First, the applicability of *the transactional net margin method* — regulated under the name of *the comparable profits method* in a similar way in the Tax Code and the Treasury Regulations<sup>680</sup> — to transfers of intangibles in the course of a business restructuring can be discussed. In general, these methods review the profitability of a related party in a controlled transaction by comparing it to the profits earned by comparable unrelated parties, using indicators that measure such a profitability or generated profits. Pursuant to the OECD Transfer Pricing Guidelines, the transactional net margin method examines “the net profit relative to an appropriate base,” which a related party realizes from a related party transaction, and compares it with net profits realized by uncontrolled parties from similar transactions. Thus, the method measures always the relationship between the net profit and an appropriate base (e.g. costs and assets). Primarily, the net profit indicator of the related party in the controlled transaction should be constituted by reference to the net profit indicator that the same related party earns in comparable

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<sup>676</sup> See e.g. OECD Transfer Pricing Guidelines, 2.6 and 2.63.

<sup>677</sup> OECD Transfer Pricing Guidelines, 2.3–2.4; Finnish Tax Administration Memorandum 1471/37/2007, pp. 36–37.

<sup>678</sup> Article 105.7 of the Tax Code.

<sup>679</sup> Treas. Reg. § 1.482-4(c)(2)(ii).

<sup>680</sup> Article 105.12 of the Tax Code; Treas. Reg. § 1.482-4(a)(2), § 1.482-5.

transactions with independent parties. However, if such internal comparables cannot be found, external comparables can be used. The relevance of the functional analysis in order to examine the comparability of the related and unrelated transactions is highlighted in this method.<sup>681</sup>

Similarly, the comparable profits method under the Tax Code tests profits derived by a controlled party from a controlled transaction against specific factors (e.g. expenses or sales). This kind of operating profit is compared to the operating profit of independent parties taking into account the functions performed, assets used and risks assumed. The Tax Code defines the operating profit parameters, which should be used to determine the operating profits in question and to decide whether the profit is arm's length. Such parameters include the profitability of sales, the profitability of costs, the profitability of commercial and administrative expenses and the profitability of assets. In addition, any other parameters, which measures the ratio of the functions performed, assets used and risks assumed to the level of profits, can be used.<sup>682</sup>

Both the Tax Code and the OECD Transfer Pricing Guidelines regulate that the method is used in similar cases where the resale price and the cost plus methods are used. On the other hand, the Tax Code explicitly limits the use of the method to situations where there are no sufficient comparables to use the resale price method or the cost plus method to a related party transaction.<sup>683</sup> All in all, the comparable profits method regulated in the Tax Code follows greatly the transactional net margin method regulated in the OECD Transfer Pricing Guidelines, and the former method is based to a large extent on the latter.<sup>684</sup>

The content of the comparable profits method is understood similarly under the U.S. transfer pricing rules. Pursuant to the Treasury Regulations, the method reviews "whether the amount charged in a controlled transaction is arm's length based on objective measures of profitability (profit level indicators) derived from uncontrolled taxpayers that engage in similar business activities under similar circumstances."<sup>685</sup> The operating profit of a controlled party is arm's length, if it corresponds to the operating profit of uncontrolled parties by using specific profit level indicators. Such profit level indicators comprise the rate of return on capital employed, financial ratios

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<sup>681</sup> OECD Transfer Pricing Guidelines, 2.64.

<sup>682</sup> Article 105.12 of the Tax Code; Grundel 2014, p. 119. These parameters conform to the net profit indicators regulated in the OECD Transfer Pricing Guidelines; see OECD Transfer Pricing Guidelines, 2.96–2.105.

<sup>683</sup> Article 105.12 of the Tax Code; OECD Transfer Pricing Guidelines, 2.64.

<sup>684</sup> Grundel 2014, pp. 116–117.

<sup>685</sup> Treas. Reg. § 1.482-5(a).



(ratio of operating profit to sales and ratio of gross profit to operating expenses) and other profit level indicators providing reliable measures.<sup>686</sup> As was the case with the Russian transfer pricing rules and the OECD Transfer Pricing Guidelines, the examination of the functions performed, resources employed and risks assumed plays an important role, when determining the comparability.<sup>687</sup>

Despite the similarities between the methods, the Treasury Regulations' comparable profits method has been sometimes regarded to be inconsistent with Article 9 of the OECD Model Tax Convention. It has been viewed that the method does not always bring the best result in terms of comparability and reliability, as it allows the aggregation of financial data, such as bundling of different type of transactions (where the similarity of functions/products is understood broadly), for the purposes of applying the method, which may not always lead to that the correct comparables for the controlled transaction are found. The transactional net margin method, on the other hand, concentrates more on finding exact comparables for the specific controlled transaction in question, and the aggregation of transactions must be validated diligently.<sup>688</sup> The OECD has even stated that other profit-based methods than mentioned in the guidelines, such as comparable profits methods, are accepted only to the extent they are consistent with the guidelines.<sup>689</sup> Nevertheless, this difference has not been considered of practical significance, especially when taking into account the aforementioned similarity of the methods, and both methods may produce an appropriate result from the perspective of the arm's length principle, if they are applied properly.<sup>690</sup>

The transactional net margin method and the comparable profits method may be applied to transactions involving intangibles especially when enough information on comparable transactions for applying the transactional methods cannot be found. This is due to the fact that the net profit indicators/profit level indicators are not affected by transactional differences to the same extent as, for instance, prices under the CUP method,<sup>691</sup> or by the similarity of products under the resale price method or the cost plus method.<sup>692</sup> Information on comparable business activities and profit levels can also be obtained more easily than information on comparable uncontrolled

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<sup>686</sup> Treas. Reg. § 1.482-5(b)(1)–(4).

<sup>687</sup> Treas. Reg. § 1.482-5(c)(2)(ii).

<sup>688</sup> Madrian – Weise 2014, p. 758; Markham 2005, pp. 109–111, 113. See also Treas. Reg. § 1.482-5(b)(i) and OECD Transfer Pricing Guidelines, 2.48, 2.98.

<sup>689</sup> OECD Transfer Pricing Guidelines, 2.62.

<sup>690</sup> Wittendorff 2010a, pp. 737–738; Markham 2005, p. 115.

<sup>691</sup> See e.g. OECD Transfer Pricing Guidelines, 2.68.

<sup>692</sup> Treas. Reg. § 1.482-5(c)(2)(iii).

transactions, which is why the transactional net margin method/comparable profits method is in practice the most used transfer pricing method in Russia, Finland and the USA.<sup>693</sup> Another strength also is that, as the method is a one-sided method (as is the case with the resale and cost plus methods), financial indicators or profit level indicators should be usually examined for transfer pricing purposes only for one of the parties to the controlled transaction.<sup>694</sup>

However, the methods may not be applied unconditionally to intercompany transactions concerning transfers of intangibles in the business restructuring context. It must be first noted that these methods may not be usually applied to transactions involving non-routine, valuable and unique contributions by both of the related parties.<sup>695</sup> As intangibles are often valuable and unique, it may be difficult to validate the applicability of the methods to transactions involving such intangibles. On the other hand, it is more common in business restructurings that only one of the related parties transfers the possibly valuable and unique intangibles to another related party in the course of the restructuring, and thus only one of the related parties makes such a valuable and unique contribution in the restructuring transactions. Therefore, from this perspective, these methods could be still applied to intangible asset transactions conducted in business restructurings, provided that the receiving related party does not make any additional unique contributions in the above-mentioned manner.<sup>696</sup>

However, a more noteworthy issue that may limit the applicability of both the transactional net margin method and the comparable profits method in business restructurings is that they provide more reliable results in controlled transactions, wherein intangibles are used and exploited (e.g. under licensing arrangements) — not transferred alone. For instance, it should be noted that the OECD has in its newest guidance specifically stated that the transactional net margin method is in general unreliable method for valuing directly intangible assets in transactions involving transfers of rights in intangibles,<sup>697</sup> and therefore it may be questioned whether the method may be applied to intercompany transfers of intangible property in business restructurings at all under Finnish law. A similar view is expressed in the Tax Code's provisions

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<sup>693</sup> Lobanov 2014, p. 66; Jaakkola et al. 2012, p. 84; Wittendorff 2010a, p. 737.

<sup>694</sup> OECD Transfer Pricing Guidelines, 2.69. However, nowadays the perspectives of each of the related parties to the transaction must be considered, when the transaction involves intangibles; see OECD Transfer Pricing Guidelines, 6.112.

<sup>695</sup> Treas. Reg. § 1.482-5(b)(2)(i) and Wittendorff 2010b, p. 329; OECD Transfer Pricing Guidelines, 2.65; Article 105.12 of the Tax Code.

<sup>696</sup> See OECD Transfer Pricing Guidelines, 2.65–2.66; Treas. Reg. § 1.482-5(b)(2)(i); Article 105.12 of the Tax Code.

<sup>697</sup> OECD Transfer Pricing Guidelines, 6.141.

and the Russian legal literature, where it has been considered that the comparable profits method may be applied primarily to controlled transactions concerning the resale of goods, provision of services/performance of work and the manufacturing of goods.<sup>698</sup> Therefore, the applicability of the method to business restructurings, which involve purely transfers of intellectual properties (or rights related thereto), may be regarded troublesome under Russian law.

On the contrary, the Treasury Regulations and the U.S. legal literature have taken a broader approach in this regard. In addition to that the comparable profits method may be applied to controlled transactions, in which the intangibles are used and/or exploited, it may be applied to transfers of rights in intangible property alone under certain circumstances. For example, it has been even considered in the Treasury Regulations that, when rights in intangible property have been transferred by a U.S. company to a foreign subsidiary, the method may bring the most reliable measure of an arm's length result in such cases.<sup>699</sup> Hence, in contrast to Russian and Finnish law, the applicability of the comparable profits method may not be ruled out under U.S. law in business restructurings, which involve transfers of intangibles/rights in intangibles. Nevertheless, it must be remembered that even in that case the method may be applied only, if it provides the most reliable measure of an arm's length result in accordance with the best method rule.

The second profit-based transfer pricing method regulated specifically under the Tax Code, the OECD Transfer Pricing Guidelines and the Treasury Regulations is *the profit split method*. As was the case with the transactional net margin method, the transactional profit split method may be applied pursuant to the OECD Transfer Pricing Guidelines only, if enough comparables cannot be found for the use of traditional transactional methods and especially for the use of the CUP method.<sup>700</sup> Similarly, according to the Tax Code, the profit split method may be applied to controlled transactions, if other regulated methods may not be applied or if the transaction involves the use of intangibles, which has a material impact on the level of profits (and comparable transactions cannot be found).<sup>701</sup> It is acknowledged under both

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<sup>698</sup> See Article 105.12 of the Tax Code; Kaftannikov 2011, p. 42.

<sup>699</sup> Treas. Reg. § 1.482-5(e) (Example 4). In the example, a U.S. developer has developed a widget that is manufactured by a foreign subsidiary, which in turn sells the finished widgets to a U.S. subsidiary of the U.S. developer for distribution and marketing activities in the USA. The comparable profits method is regarded appropriate to examine whether the foreign manufacturer's compensation (a yearly royalty) to the U.S. developer for the technology behind the widget is arm's length. See also e.g. Wittendorff 2010b, pp. 328–332, where similar views have been expressed.

<sup>700</sup> OECD Transfer Pricing Guidelines, 6.148.

<sup>701</sup> Article 105.13 of the Tax Code.

Russian law and the OECD Transfer Pricing Guidelines that the profit split method may be applied expressly to related party transaction involving transfers of intangible assets or rights in intangible assets (in Russia, transfers of intellectual property or rights related thereto),<sup>702</sup> which must be naturally taken into account in business restructurings involving such transfers. The Treasury Regulations regulate correspondingly the profit split method as one of the transfer pricing methods that may be applied explicitly to transfers of intangible property,<sup>703</sup> but they do not contain a similar priority order of transfer pricing methods, as discussed above.

The profit split method examines whether the division of profits realized from a controlled transaction or business activity is arm's length, i.e. conforms to what independent parties would have expected to realize from participating in such a transaction or business activity. In general, the method examines first the combined (operating) profits to be split from the controlled transaction for the related parties, after which the profits will be distributed among the parties in the same manner as it would be done between independent parties. It is of great importance to review the functions performed, risks assumed and assets used by each related party participated in the transaction. The method is understood to a great degree similarly under the OECD Transfer Pricing Guidelines, the Tax Code and the Treasury Regulations.<sup>704</sup>

The OECD Transfer Pricing Guidelines and the Tax Code provide two approaches to the determination of the combined profit realized from a business activity and allocation thereof between related parties. The first approach is *the contribution analysis* where the combined profits (total profits earned by the related parties from the related transaction(s) in question) are divided between the related parties on the basis of "a reasonable approximation of the division of profits that independent enterprises would have expected to realize from engaging in comparable transactions." If no data on comparables can be found, the division shall be made pursuant to the relative value of the functions performed, risks assumed and assets used by each party to the transaction.<sup>705</sup> The second approach, *the residual analysis*, is divided into two stages. At first, each controlled party receives an arm's length compensation for its routine contributions/performances in the controlled transaction(s) in question. In general, such compensations shall be determined by applying one of the traditional transactional methods or a

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<sup>702</sup> See e.g. Hellevig – Usov – Kabakov 2014, p. 234; OECD Transfer Pricing Guidelines, 6.148.

<sup>703</sup> Treas. Reg. § 1.482-4(a)(3), § 1.482-6.

<sup>704</sup> OECD Transfer Pricing Guidelines, 2.114, 2.122; Article 105.13 of the Tax Code; Treas. Reg. § 1.482-6(a)–(b).

<sup>705</sup> OECD Transfer Pricing Guidelines, 2.125, 2.130. Corresponding provisions are regulated in Article 105.13 of the Tax Code.

transactional net margin method/comparable profits method. After the first stage, any residual profit (loss), which is possibly left, shall be allocated among the controlled parties in accordance with the analysis of relevant facts and conditions as provided in the first approach, the contribution analysis.<sup>706</sup>

There are two different alternatives to apply the profit split method also pursuant to the Treasury Regulations. The first alternative, *the comparable profit split method*, evaluates whether there are comparable transactions between unrelated parties, and “a comparable profit split is derived from the combined operating profit of uncontrolled taxpayers whose transactions and activities are similar to those of the controlled taxpayers in the relevant business activity.”<sup>707</sup> The second alternative, *the residual profit split method*, allocates the combined operating profit in a two-step process. First, the operating income is allocated to each related party in the related party transaction to provide “a market return for its routine contributions to the relevant business activity.” In the second step, the residual profit is divided among the related parties according to the relative value of their non-routine contributions, in this case, the contributions of intangible property, to the relevant business activity.<sup>708</sup> Thus, these two forms of the profit split method are quite extensively comparable to the above-mentioned forms of profit split method, based either on the contribution analysis or the residual analysis, under the OECD Transfer Pricing Guidelines and the Russian Tax Code.<sup>709</sup>

One of the advantages of the profit split method is that it does not rely as closely on finding comparables for the controlled transaction as other methods, and therefore it may be used in situations where valuable and unique intangibles are present in the transactions and no exact or sufficient comparables can be found for the intangibles. In such situations, the allocation of profits may be based on the division of the functions between the controlled parties in question, taking into consideration the assets used and risks

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<sup>706</sup> OECD Transfer Pricing Guidelines, 2.127; Article 105.13 of the Tax Code. Both the OECD Transfer Pricing Guidelines and the Tax Code contain also more specific provisions on how to determine ratios pursuant to which the combined profit will be allocated between the parties. The allocation may be based on, among other things, comparable transactions, assets employed and expenses occurred; see in more detail in OECD Transfer Pricing Guidelines, 2.138–2.151 and Article 105.13 of the Tax Code.

<sup>707</sup> Treas. Reg. § 1.482-6(c)(2)(i).

<sup>708</sup> Treas. Reg. § 1.482-6(c)(3)(i)(A)–(B). The relative value of non-routine intangible property contributed by controlled parties may be measured, for example, by external market benchmarks or by the capitalized cost of developing the intangible property (less amortization), see more in Treas. Reg. § 1.482-6(c)(3)(i)(B)(2).

<sup>709</sup> Small differences, which are more of technical nature, can nevertheless be found between the OECD’s and the Treasury Regulation’s approaches; see e.g. in Wittendorff 2010a, p. 756, Wittendorff 2010b, p. 335 and Markham 2005, pp. 121–125.

borne.<sup>710</sup> It also provides a reliable measure for determining the arm's length compensation in situations where both parties of the controlled transaction contribute to the transaction with unique, non-routine intangibles. On the other hand, it has been viewed that the method may be difficult to apply in practice, as obtaining the required financial information from all the participating parties may not be an easy task. In addition, it may be challenging to measure the combined profits and costs for all the related parties in the controlled transaction(s).<sup>711</sup>

From a business restructuring perspective, the profit split method may bring more reliable results especially in the related party transactions, which involve transfers of intangibles, as the method takes into account unique and valuable contributions, such as valuable intangibles of the parties. In particular, the method may be useful in business restructuring transactions, which concern the use of unique intangibles by both of the related parties, such as licensing arrangements concluded after amending the manufacturing or distribution activities of a group company. On the other hand, these kinds of transactions, where both parties make non-routine contributions with valuable intangibles to a business activity, are in nature more *post-restructuring transactions* than transactions performed *in the course of a business restructuring*, as usually in business restructurings the assets of a restructured entity are transferred in a controlled manner to one group company, as discussed earlier. Therefore, the method's focus is more on intercompany transfers of commodities and services, where intangibles are used and exploited, than on actual transfers of intangible assets or rights in intangibles. This may cause difficulties in applying the method alone to transfers of intangible property occurring during a business restructuring.

Nevertheless, the OECD Transfer Pricing Guidelines have in its newest provisions also stated that the method "can be utilized to determine the arm's length conditions for a transfer of intangibles or rights in intangibles where it is not possible to identify reliable comparable uncontrolled transactions for such transfers" and that the method "may have application in connection with the sale of full rights in intangibles,"<sup>712</sup> which leads to that it could also be used in business restructurings, which involve separate transfers of intangibles or rights in intangibles between associated parties. Correspondingly, in the U.S. legal literature it has been commonly viewed that the method may also be applied to controlled transactions involving transfers of ownership of

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<sup>710</sup> OECD Transfer Pricing Guidelines, 2.115–2.117.

<sup>711</sup> OECD Transfer Pricing Guidelines, 2.115, 2.120; Grundel 2014, p. 121; Wittendorff 2010b, p. 335.

<sup>712</sup> OECD Transfer Pricing Guidelines, 6.148–6.149.

intangible property,<sup>713</sup> and therefore its applicability should be considered also in U.S. business restructurings.

It must, however, be observed that the OECD has in recent years paid more specific attention to the application of the profit split method. As part of its BEPS Project, the OECD has discussed and introduced several proposals for improvements in this regard.<sup>714</sup> Pursuant to the OECD's discussion draft on the revised guidance on profit splits, the application of the profit split method may be considered especially in situations where "it can offer a solution for cases where both parties to a transaction make unique and valuable contributions (e.g. contribute unique and valuable intangibles) to the transaction," as reliable information on comparables may not necessarily exist in such situations. On the other hand, if one party to a related party transaction "performs only simple functions" (i.e. does not make unique and valuable contributions), the method may not be applied purely for the reason that close comparables cannot be found for the use of other methods.<sup>715</sup> In general, the OECD is willing to limit the inappropriate use of the profit split method and is of the opinion that a more reliable arm's length result may be usually achieved by making adjustments to the comparables available (although they might be imperfect) rather than applying the profit split method inappropriately.<sup>716</sup>

This may result in that it may be more difficult to validate the use of the method in future also in business restructurings, if related parties could apply other transfer pricing methods by making appropriate adjustments to possible material differences between the controlled transaction occurred in the restructuring and comparable uncontrolled transaction(s). Nonetheless, it must be noted that when such adjustments cannot be made, and thus comparables found, the use of the profit split method may still be considered in the transfer pricing of intangibles; the OECD repeated in the discussion draft its view on the possibility of using the method in controlled transactions involving merely transfers of intangibles.<sup>717</sup>

All in all, the following conclusions can be drawn from the aforementioned transfer pricing methods. All the target countries prefer the use of the CUP/CUT method in controlled transactions involving transfers of intangibles

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<sup>713</sup> Wittendorff 2010b, p. 333.

<sup>714</sup> See about the discussion with regard to the OECD's intent to revise the guidance related to the profit split method in Panayj 2015, pp. 112–113.

<sup>715</sup> OECD Public Discussion Draft on Revised Guidance on Profit Splits, 6 and 14. See also OECD BEPS Actions 8–10, pp. 55–61.

<sup>716</sup> OECD Public Discussion Draft on Revised Guidance on Profit Splits, 14; OECD BEPS Actions 8–10, pp. 60–61.

<sup>717</sup> OECD Public Discussion Draft on Revised Guidance on Profit Splits, 18.

at least to some extent. Thus, the possible use of the CUP/CUT method must primarily be considered also in business restructurings.<sup>718</sup> As intangible assets usually have unique features and characteristics, it may be prove to be difficult to find comparables for the controlled transactions involving transfers of them. In such situations, the potential applicability of other transfer pricing methods must be reviewed, especially if appropriate adjustments cannot be made to eliminate potential substantial differences between the controlled and uncontrolled transactions. Albeit the use other transactional methods (the resale price method and cost plus method) is not limited to transfers of tangibles assets under the Russian and Finnish transfer pricing rules — in contrast to the U.S. regulations — it is unlikely that they could bring the most appropriate results in terms of the arm's length principle, when they are applied to transactions involving solely transfers of intangibles; they do not take into account in a sufficient manner the transfer pricing aspects of transfers of intangibles, particularly in the business restructuring context.

Consequently, it is likely that the applicability of the profit-based transfer pricing methods must be examined quite often in business restructurings — in addition to the CUP/CUT method — if the restructurings involve transfers of intangibles. Although the transactional net margin method/the comparable profits method may be applied to transactions involving intangibles in general under the Tax Code and the OECD Transfer Pricing Guidelines, the profit split method can be applied more effectively to transactions involving purely transfers of intangible assets, as it acknowledges the unique nature of intangibles and has been considered to be more suitable for direct valuation of intangibles. This is line also with the OECD's latest guidance in relation to transfer pricing of intangibles, where it has been expressly stated that from all the discussed transfer pricing methods the CUP method and the profit split method most likely prove to be the most useful in matters involving transfers of intangible assets.<sup>719</sup> In contrast to the Russian and the Finnish (OECD based) approaches, the comparable profits method may under the U.S. transfer pricing rules also be applied to the controlled transfers of rights in intangible property on certain occasions, which leads to that the applicability of both profit-based transfer pricing methods should also be considered in cross-border business restructurings under U.S. tax law.

As the target countries also allow the use of such methods in determining arm's length compensations for transfer of intangibles, Russia, Finland and the USA seem to follow the arm's length principle in this respect. However, in one respect, amendments to the existing transfer pricing rules and guidance

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<sup>718</sup> Russian practitioners are also of the same opinion, see Expert Interview 2012. Pursuant to the practitioners, the CUP method has turned out to be the most used method in practice.

<sup>719</sup> OECD Transfer Pricing Guidelines, 6.145.



could be considered *de lege ferenda*. As mentioned above, the application of the profit split method usually requires that both parties of a related party transaction make unique and valuable contributions (e.g. use unique and valuable intangibles). Nevertheless, it has been confirmed in the above-mentioned manner that the method can be used in transactions involving purely transfers of intangibles. As in such transactions only one party *de facto* makes unique contributions, i.e. transfers unique and valuable intangibles, it should be clarified in the transfer pricing rules, how the method should be applied particularly in such circumstances. The current situation may thus cause difficulties in applying the method alone to transfers of intangible property occurring during a business restructuring.

#### 4.3.4 INTANGIBLE ASSETS: OTHER VALUATION METHODS

It is generally acknowledged that the regulated transfer pricing methods may not always provide sufficient tools for determining the arm's length compensations for intercompany transfers of intangible assets, for instance, due to that reliable comparable uncontrolled transactions cannot be found for the related party transactions in question. On the other hand, it may also be the case that independent parties would in comparable transactions use other techniques to value intangibles than the aforesaid specific transfer pricing methods. National tax legislation may under certain circumstances therefore allow taxpayers to use also other valuation methods than expressly specified transfer pricing methods in the determination of the arm's length compensation for intangible assets transferred between associated parties, if such transfer pricing methods cannot be applied to a particular case. This approach has been applied also by the Russian, Finnish and U.S. tax law.

According to the OECD Transfer Pricing Guidelines, the use of the so-called unspecified methods can be justified, if they provide the most appropriate result in terms of the arm's length principle. The use of such methods must be validated in the transfer pricing documentation, and they cannot be used in substitution for the above-mentioned specified transfer pricing methods, if the latter methods could be applied to the related party transaction in question.<sup>720</sup> The use of other valuation methods in transactions involving transfers of intangibles has been discussed indirectly also in Chapter IX of the OECD Transfer Pricing Guidelines. Pursuant to the guidelines,

“[D]ifficulties can arise in the context of business restructuring where the valuation of an intangible or rights in an intangible at the time of the transaction is highly uncertain. In these cases, the question arises as to

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<sup>720</sup> OECD Transfer Pricing Guidelines, 2.9.

how arm's length pricing should be determined. The question should be resolved, both by taxpayers and tax administrations, by reference to *what independent enterprises would have done in comparable circumstances* to take account of the valuation uncertainty in the pricing of the transaction. ---"<sup>721</sup>

As independent parties would likely use other financial valuation methods than the specified transfer pricing methods in situations where transfer pricing methods do not provide a sufficient tool to estimate the value for a transfer of an intangible asset, such methods could also be used in business restructuring in order to determine the arm's length price for the transfers of intangibles between associated parties. Chapter VI of the OECD Transfer Pricing Guidelines contains more specific guidance on the application of other valuation techniques to intangibles transferred in controlled transactions, which has been recently also updated as part of the BEPS Project. The starting point is that, "in situations where reliable comparable uncontrolled transactions for a transfer of one or more intangibles cannot be identified, it may also be possible to use valuation techniques to estimate the arm's length price for intangibles transferred between associated enterprises." Such valuation techniques may be used as a part of one of the specific transfer pricing methods or independently.<sup>722</sup> The valuation techniques must also be applied in a manner, which is consistent with the principles of the OECD Transfer Pricing Guidelines and ultimately with the arm's length principle.<sup>723</sup>

It is noteworthy to mention that the Finnish Tax Administration has confirmed the possibility of using other valuation methods than which are specifically regulated in the OECD Transfer Pricing Guidelines, which supports the view that such methods may also be used in the Finnish transfer pricing of intangibles.<sup>724</sup> The Russian transfer pricing rules allow similarly the use of unspecified valuation methods. Pursuant to the Tax Code, if taxpayers may not use the transfer pricing methods specifically regulated in the Tax Code, other valuation techniques may be used in one-off transactions to estimate the arm's length price. However, the determination of an arm's length

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<sup>721</sup> OECD Transfer Pricing Guidelines, 9.62. See also the new paragraph in Chapter VI, paragraph 6.181, stating the same. Apart from that the guidance of Chapter VI of the OECD Transfer Pricing Guidelines is applicable as such to business restructurings, Chapter IX contains specific references to Chapter VI; see e.g. OECD Transfer Pricing Guidelines, 9.56, 9.62 and 9.63.

<sup>722</sup> OECD Transfer Pricing Guidelines, 6.153.

<sup>723</sup> OECD Transfer Pricing Guidelines, 6.154.

<sup>724</sup> Finnish Tax Administration Memorandum 1471/37/2007, p. 37. The memorandum expressly refers to the OECD Transfer Pricing Guidelines in this respect, and therefore the OECD's guidance is primarily to be followed, when other valuation techniques are used in determining the arm's length compensation for intercompany transfers of intangibles.

price by using such unspecified techniques may be conducted only by an independent valuation appraiser.<sup>725</sup> Therefore, if a business restructuring involves transfers of intellectual property between associated parties, and transfer pricing methods specified in the Tax Code cannot be used in this particular case, other valuation methods may be used to validate the pricing of the intellectual property provided that such a valuation is based on an independent valuation expert's opinion. Despite this technical difference between the OECD Transfer Pricing Guidelines and the Tax Code, both sources in practice require that other valuation methods cannot be used, if a reliable arm's length result may be achieved by using regulated and specified transfer pricing methods.

The legal basis for using other valuation methods than specified transfer pricing methods in U.S. intangible property transactions can be found in the Treasury Regulations. Pursuant to the regulations, unspecified methods may be used to examine whether the amount charged in a related party transaction involving transfers of intangibles is arm's length.<sup>726</sup> When doing so, the principle of the arm's length standard must be followed: "In establishing whether a controlled transaction achieved an arm's length result, an unspecified method should provide information on the prices or profits that the controlled taxpayer could have realized by choosing a realistic alternative to the controlled transaction. As with any method, an unspecified method will not be applied unless it provides the most reliable measure of an arm's length result under the principles of the best method rule."<sup>727</sup> From the above mentioned, it can be seen that the U.S. approach is to a great degree comparable with the provisions of the OECD Transfer Pricing Guidelines and the Tax Code.

Generally, there are three kinds of valuation methods or techniques that are commonly used by independent parties in the financial reporting and generally in corporate finance to value intangibles. These are *the income based methods*, *the cost based methods* and *the market based methods*.<sup>728</sup> It must be noted that all of these methods have been expressly recognized and regulated as applicable methods in the valuation activities of independent

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<sup>725</sup> Article 105.7 of the Tax Code. In this context, the Tax Code refers to the Act on Valuation Activities (135-FZ, Federal'nyj zakon ot 29 iyulya 1998 g. N 135-FZ "Ob otsenочноj deyatel'nosti v Rossijskoj Federatsii"), which deals with the valuation activities of independent appraisers in more detail. The provisions of the act must be taken into account, when independent appraiser is used to value transfers of intellectual properties between related parties.

<sup>726</sup> Treas. Reg. § 1.482-4(a), § 1.482-4(d)(1).

<sup>727</sup> Treas. Reg. § 1.482-4(d)(1).

<sup>728</sup> See e.g. Wittendorff 2010b, p. 326; Jaakkola et al. 2012, p. 322; Karjalainen – Raunio 2007, p. 165; Van Herksen – Levey – Fletcher 2008, p. 8.

appraisers under Russian law,<sup>729</sup> and thus they may be applied to controlled transfers of intellectual properties in business restructurings as other valuation methods in addition to the regulated transfer pricing methods. On the other hand, the OECD Transfer Pricing Guidelines and the Finnish Tax Administration's memorandum have explicitly mentioned only the income based methods,<sup>730</sup> while the Treasury Regulations have not discussed the types of methods that could be regarded as unspecified methods, at all.<sup>731</sup> Nevertheless, the OECD Transfer Pricing Guidelines have stated that also other valuation techniques can be considered in the transfer pricing analysis of intangibles, provided that such techniques are applied in an appropriate manner in accordance with the guidelines' principles.<sup>732</sup> In addition, despite the lack of particular mentions in the legislated provisions and regulations, it has been confirmed broadly in the various sources of Finnish and U.S. tax law that all the three methods may be regarded as unspecified methods, which may be used in determining the arm's length compensation for intangible assets transferred between related parties.<sup>733</sup>

The income based methods evaluate the value of an intangible asset on the basis of future (net) profits, cash flow or other economic benefits the asset may generate during its lifetime. This means that the useful lifetime of the intangible asset and the future income generated by it over its lifetime must be

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<sup>729</sup> While the valuation activity is regulated under the Act on Valuation Activities, the valuation methods are regulated in the Resolution No 297 of the Ministry of Economic Development of the Russian Federation, see Prikaz Minehkonmrazvitiya Rossii ot 20.05.2015 N 297 "Ob utverzhenii Federal'nogo standarta otsenki "Obshhie ponyatiya otsenki, podkhody i trebovaniya k provedeniyu otsenki (FSO N 1)" (hereinafter, Resolution 297 of the Ministry of Economic Development).

<sup>730</sup> See OECD Transfer Pricing Guidelines, 6.153 and 6.157; Finnish Tax Administration Memorandum 1471/37/2007, p. 37.

<sup>731</sup> Treas. Reg. § 1.482-4(d)(1).

<sup>732</sup> "[I]t is not the intention of these [G]uidelines to endorse or reject one or more sets of valuation standards utilized by valuation or accounting professionals or to describe in detail or specifically endorse one or more specific valuation techniques or methods as being especially suitable for use in a transfer pricing analysis. However, where valuation techniques are applied in a manner that gives due regard to these [G]uidelines, to the specific facts of the case, to sound valuation principles and practices, and with appropriate consideration of the validity of the assumptions underlying the valuation and the consistency of those assumptions with the arm's length principle, such techniques can be useful tools in a transfer pricing analysis where reliable comparable uncontrolled transactions are not available"; see OECD Transfer Pricing Guidelines, 6.156.

<sup>733</sup> See e.g. decision KHO 2014:3 of the Finnish Supreme Administrative Court and the preliminary rulings practice of the Finnish Large Taxpayers' Office in Laaksonen 2004, pp. 425–427 and Waal – Pykönen 2014, p. 558. See also Pankakoski 2015, pp. 286–290; Jaakkola et al. 2012, p. 322; Linnanvirta – Rapo 2012, pp. 277–278; Laaksonen 2004, pp. 425–427; Wittendorff 2010a, p. 658; Wittendorff 2010b, pp. 326–327; Brauner 2008, p. 121; Boos 2003, pp. 75–87.

projected, and such future income must also be discounted to the present value.<sup>734</sup> One application of the income based methods is *the relief from royalty method*, which determines the value of an intangible property by referring to the present value of royalty payments the owner of the asset saves by owning the intangible property.<sup>735</sup> Another income based method is *the excess earnings method*, which determines the value of an intangible asset by reference to the present value of (future) earnings attributable to the intangible asset after excluding the part of earnings that are attributable to other assets of the company/business.<sup>736</sup> *The incremental cash flow method*, on the other hand, values the intangible asset on the basis of comparing the cash flow of a business exploiting the intangible asset to the cash flow of a business operating without the corresponding intangible asset.<sup>737</sup> In particular, *the discounted cash flow method*, which calculates the discounted value of projected cash flows derived from the exploitation of an intangible asset, is a good example of an often-used income based method.<sup>738</sup> Such income based methods may be used to estimate especially the values of patents, trademarks or other intangibles, which generate cash flows.<sup>739</sup> It should be noted that these kinds of intangibles are commonly transferred in business restructurings between associated parties.

The cost based methods estimate the value of an intangible asset principally on the basis of the costs of creating the intangible asset. The cost based approach requires that the costs can be identified in a precise manner. The advantage of the cost based methods is that the required information on costs is generally readily available for the company or can be reproduced without difficulty. Trademarks, however, can be regarded as an exception, as it is usually difficult to obtain sufficient information on their development costs.<sup>740</sup> Nonetheless, it must be noted that it has been generally considered that there is no clear correlation between the development costs of an intangible asset and its value, and therefore the cost based methods have been regarded as unreliable measures for determining the value for an intangible property in

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<sup>734</sup> Resolution 297 of the Ministry of Economic Development; Wittendorff 2010b, p. 326; Karjalainen – Raunio 2007, p. 167; Boos 2003, p. 81; Kozyrev – Makarov 2003, p. 139; Rimer 2014, p. 335.

<sup>735</sup> Jaakkola et al. 2012, p. 323; Kozyrev – Makarov 2003, p. 146.

<sup>736</sup> Wittendorff 2010b, p. 327.

<sup>737</sup> Linnanvirta – Rapo 2012, p. 277.

<sup>738</sup> OECD Transfer Pricing Guidelines, 6.153, 6.157; Finnish Tax Administration Memorandum 1471/37/2007, p. 37.

<sup>739</sup> Kozyrev – Makarov 2003, p. 140. See more about other income based methods applicable to intangibles, such as the direct cash flow method, in Jaakkola et al. 2012, pp. 322–327 and Linnanvirta – Rapo 2012, pp. 277–278.

<sup>740</sup> Resolution 297 of the Ministry of Economic Development; Azgaldov – Karpova 2006, pp. 87–89; Rimer 2014, p. 335; Karjalainen – Raunio 2007, p. 166.

general and therefore also for transfer pricing purposes.<sup>741</sup> The OECD has also shared this view, as it does not recommend the use transfer pricing methods that seek to determine the value of intangibles on the basis of the costs of developing such intangibles.<sup>742</sup> Basically, the potential use of the cost based methods is limited to cases, where the intangible asset has recently been acquired/developed and the costs related thereto can be identified in a reliable manner.<sup>743</sup>

Finally, the market based methods — also known as the market approach — determine the value of an intangible asset by reference to the values paid for the same or similar intangibles on the market between independent parties.<sup>744</sup> The market based methods conform thus to a large extent to the specified CUP/CUT methods regulated under the national transfer pricing rules and the OECD Transfer Pricing Guidelines. Consequently, the market approach encounters the same challenges as the corresponding transfer pricing methods: most importantly, proper comparable transactions must be established. If sufficiently comparable transactions cannot be found, even after making adjustments to eliminate possible differences, the market based methods do not provide useful help in estimating an arm's length value for intangibles transferred between related parties. As the lack of comparables is often the reason why (transactional) transfer pricing methods may not be applied to transfers of intangible assets in the first place and other valuation techniques are considered, the market based methods are not likely that useful tools also in business restructurings, which involve controlled transfers of intangible assets.

From the above mentioned, it can be stated that the income based methods are likely to provide the best arm's length results in comparison with other unspecified methods, if regular transfer pricing methods cannot be applied in a particular case to intangibles transferred in the course of a business restructuring. As discussed, the relation between the costs and the value of an intangible asset is widely questioned, and the market approach does not bring sufficient results in situations where reliable comparable uncontrolled transactions cannot be found. Therefore, it is not a surprise that there exists widespread support for the primary use of the income based methods over other unspecified methods also pursuant to the OECD Transfer Pricing

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<sup>741</sup> Wittendorff 2010b, p. 326; Linnanvirta – Rapo 2012, p. 278; Boos 2003, pp. 75–78.

<sup>742</sup> OECD Transfer Pricing Guidelines, 6.142.

<sup>743</sup> Karjalainen – Raunio 2007, p. 166.

<sup>744</sup> Resolution 297 of the Ministry of Economic Development; Jaakkola et al. 2012, p. 322; Boos 2003, pp. 78–81.

Guidelines and Finnish, Russian and U.S. law.<sup>745</sup> For instance, it has been stated in the OECD Transfer Pricing Guidelines that, in particular, the valuation methods that are based on the calculation of the discounted value of projected future income streams or cash flows, which are derived from the exploitation of the transferred intangible asset, may be “particularly useful” in cases where reliable comparables cannot be identified for the controlled transfer of intangible.<sup>746</sup>

In the business restructuring context, this means that in cases where the regulated transfer pricing methods may not be applied to intangibles transferred between related parties, the applicability of the income based methods — especially methods based on the estimation of the discounted value of future cash flows or income streams — must be first considered before examining the applicability of any other unspecified methods.<sup>747</sup> As it is unlikely that the cost based and market based methods would provide alone reliable measures for determining an arm’s length price for a transfer of intangibles, the combination of these methods could be considered merely in situations, in which the income approach cannot be applied solely or together with other income methods. As the existing situations in the target countries allow the use of such valuation methods that are also frequently used in similar transactions between independent parties, in particular the income method, the arm’s length principle is followed in this respect.

#### 4.3.5 GOING CONCERN

When a business restructuring involves a transfer of a functioning, economically integrated business unit (i.e. going concern), it may be required

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<sup>745</sup> OECD Transfer Pricing Guidelines, 6.153–6.178; Pankakoski 2015, p. 287; Linnanvirta – Rapo 2012, pp. 277–278; Wittendorff 2010b, p. 326; Brauner 2008, p. 120; Ivanov – Baranov 2008, p. 348; Kozyrev – Makarov 2003, p. 139. The use of income based methods in direct valuation of intangibles for transfer pricing purposes has also been accepted recently in the preliminary rulings practice of the Finnish Large Taxpayers’ Office, see Waal – Pykönen 2014, p. 557. Also, the Russian practitioners have stated in an interview that they use more often the income based methods when determining the arm’s length prices for transfers of intellectual properties, see Expert Interview 2012.

<sup>746</sup> OECD Transfer Pricing Guidelines, 6.153, 6.157. The Finnish Tax Administration has also expressly mentioned as an example of valuation methods that could be used to value intangibles the methods, which calculate the discounted value of projected future cash flows; see Finnish Tax Administration: Transfer Pricing of Intangibles.

<sup>747</sup> Regardless of being the most appropriate method of the discussed three methods, it is not an easy task to apply the income based methods in practice, as, for instance, it may be difficult to project the cash flow and/or choose the correct discount rate. See more in e.g. Vinokurova 2015, p. 21; Ivanov – Baranov 2008, p. 348; OECD Transfer Pricing Guidelines, 6.158–6.178; Brauner 2008, pp. 119–120.

that contemporaneous transfers of assets, risks, and/or functions executed between related parties in the course of the business restructuring shall be reviewed and valued under Finnish and U.S. law on an aggregate basis, as discussed earlier. This basically means that the determination of separate arm's length compensations for each asset transfers occurring in the business restructuring would not be necessary in such situations, as only one transfer price shall be determined — the arm's length compensation for the transfer of a business as a going concern.

As with any other transfer pricing cases, the use of the specifically regulated transfer pricing methods, especially the CUP/CUT method, must also be considered as a starting point in business restructurings, which involve transfers of a going concern. However, as the valuation of the transfer of a going concern “should reflect all the valuable elements that would be remunerated between independent parties in comparable circumstances,”<sup>748</sup> the use of the specified transfer pricing methods may be difficult or they may provide unreliable results. Therefore, the OECD Transfer Pricing Guidelines have suggested that the arm's length compensation could be in such cases determined by using the same methods that independent parties would use in similar transactions, i.e. by using valuation methods that are commonly used in business acquisition deals between independent parties. As mentioned earlier, the OECD states that “valuation techniques that are used, in acquisition deals, between independent parties may prove useful to valuing the transfer of an ongoing concern between associated enterprises.”<sup>749</sup>

The OECD Transfer Pricing Guidelines also provide an example, which elaborates the approach. In the example, the manufacturing activities of a group company are relocated to another group company in a different jurisdiction. In such a scenario, the former company transfers machinery, inventories, patents, manufacturing processes and know-how as well as key customer and commercial contracts to the latter company. In addition, several employees are relocated in connection with such transfers to the latter company. Such contemporaneous transfers could be regarded as a transfer of a going concern had it occurred between unrelated parties. Pursuant to the guidelines, “in order to determine the arm's length remuneration, if any, of such a transfer between associated enterprises, it should be compared with a transfer of an ongoing concern between independent parties rather than with a transfer of isolated assets.”<sup>750</sup>

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<sup>748</sup> OECD Transfer Pricing Guidelines, 9.68.

<sup>749</sup> OECD Transfer Pricing Guidelines, 9.69.

<sup>750</sup> OECD Transfer Pricing Guidelines, 9.70.



The principles and regulations of the OECD Transfer Pricing Guidelines can and should be used in their present form (Chapter IX included) as a guide for the application of the arm's length principle in Finland.<sup>751</sup> Therefore, the above-discussed OECD's approach — the use of valuation methods commonly used in acquisition deals between independent parties — should be taken as the starting point under Finnish law, when an arm's length compensation is determined for a transfer of a going concern in a business restructuring. This view is supported by the fact that even before Chapter IX of the OECD Transfer Pricing Guidelines was adopted, the Finnish Large Taxpayers' Office took in its preliminary rulings practice a similar approach. The Finnish Large Taxpayers' Office stated that business restructurings may be regarded as transfers of a going concern for transfer pricing purposes under certain circumstances. In such cases, the arm's length compensation shall be determined solely for the transferred business unit, and there is no need to value e.g. intangibles, which belong to such a unit, separately. In the discussed business restructuring example, the market value of the transferred business was not determined by using transfer pricing methods, but on the basis of income generated by the transferred business. In practice, this meant that the Finnish Large Taxpayers' Office deducted from the group's market value the balance sheet values of businesses (or parts of businesses) that were not transferred in the business restructuring from the restructured group company to another group company, and the remaining value was thus considered to be the current value of the transferred business. Also, other appropriate valuation methods could be applied to business restructurings concerning transfers of a going concern according to the Finnish Large Taxpayers' Office.<sup>752</sup>

In the legal literature, it has been viewed that the Finnish Tax Administration's guidance on the valuation of assets in the estate and gift taxation<sup>753</sup> may also serve as a guide in business restructurings, when a going concern is transferred between related parties.<sup>754</sup> Pursuant to the guidance, the business assets are examined as a whole, and taxpayers should primarily use comparables, when determining the market value for such a bundle of assets.<sup>755</sup> If sufficient comparables cannot be found, the value for the business shall be estimated on the basis of current net asset value and the yield value.<sup>756</sup> If the yield value

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<sup>751</sup> See KHO 2013:36 and Finnish Tax Administration: Statement A177/200/2015.

<sup>752</sup> Laaksonen 2006, pp. 435–436.

<sup>753</sup> Finnish Tax Administration Memorandum A182/200/2015.

<sup>754</sup> Juusela – Tuominen 2011, pp. 317–319.

<sup>755</sup> Finnish Tax Administration Memorandum A182/200/2015, p. 31.

<sup>756</sup> Finnish Tax Administration Memorandum A182/200/2015, pp. 31, 35. The net asset value is the difference between the company's (business') assets and liabilities. In this calculation, the assets' market values shall be used. Primarily, the values used on the balance sheet are regarded as the market values.

exceeds the net asset value, the average of both the net asset value and the yield value must be used. On the contrary, if the net asset value exceeds the yield value, the net asset value forms the market value of the business (i.e. bundle of business assets). Nevertheless, also specific circumstances should be taken into consideration on a case-by-case basis, meaning that it may be necessary that one of the values is weighted under certain circumstances. Therefore, if, for example, the business relies heavily on different kinds of intangible assets, which are not recorded on the company's balance sheet, the market value of the business may be solely the calculated yield value.<sup>757</sup>

The Finnish Tax Administration also accepts the use of other valuation methods in its memorandum, given that the valuation can be based on broader facts of the case than what is dealt with in the memorandum. However, regardless of which valuation method is used in a particular case, the minimum value of a company/business shall always be deemed to be for tax purposes the value calculated on the basis of the net asset value.<sup>758</sup>

Although the aforementioned memorandum regulates the valuation principles especially in the estate and gift taxation context, it represents the viewpoint of the Finnish Tax Administration in general. Consequently, as the Finnish Tax Administration provides in the discussed manner specific guidance with regard to the determination of the value for transfers of a business or complex of assets for tax purposes, it may be reasonable to follow the principles set out in the guidance also in other situations involving the valuation of a business, provided that such calculations would result in a reliable and appropriate result. Hence, the guidance should also be taken into consideration in business restructurings. Therefore, the arm's length compensation for the transfer of a going concern occurred in the course of a business restructuring can be determined — and perhaps may be even required by the Finnish Tax Administration — on the basis of the current net asset value and the yield value as set out above, if it would bring the most reliable arm's length result.

On the other hand, if the circumstances of the business restructuring do not allow the use of the methods discussed in the memorandum and require that other factors must be taken into account, other valuation methods that are

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However, if this is not the case, the values on the balance sheet are adjusted to correspond to their (real) market values. The yield value, on the other hand, is calculated primarily on the basis of the net profit calculations of the last three financial periods. Extraordinary items and year-end allocations are then eliminated from such net profits. Finally, the average of such calculations is discounted with a discount rate (usually with a rate of 15 percent). See more about calculating the net asset value and yield value in Finnish Tax Administration Memorandum A182/200/2015, pp. 32–35.

<sup>757</sup> Finnish Tax Administration Memorandum A182/200/2015, pp. 35–36.

<sup>758</sup> Finnish Tax Administration Memorandum A182/200/2015, p. 31.

generally used in the valuation of companies and/or businesses by independent parties may also be considered. This is due to the fact that the Finnish Tax Administration also accepts the use of other valuation methods in the above-discussed manner; in such situations, the calculated value must nevertheless ultimately equal at least to the net asset value of the business. The use of other valuation methods may also be supported by reference to the discussed provisions of Chapter IX of the OECD Transfer Pricing Guidelines, pursuant to which other valuation techniques that are used between unrelated parties may be of practical relevance.<sup>759</sup>

Such other valuation methods that could be used in determining the value for transfers of a going concern have been discussed in the Finnish transfer pricing legal literature. These kinds of methods are *the cash flow based, market based and net asset value based methods*.<sup>760</sup> They are commonly used by independent parties, for instance, in business acquisitions, and therefore they could also be applied to transfers of a going concern in the business restructuring context.

The cash flow based method is in general considered the most appropriate and transparent method to determine the value for a going concern, and therefore it is also commonly used.<sup>761</sup> It can be regarded as one variation of calculating the yield value of a business. The most used cash flow method is *the discounted cash flow method*. The method calculates the present value of the projected future cash flows. The analysis consists of projecting the future free cash flows, which are discounted to the present value by using an appropriate discount rate, the weighted average cost of capital (WACC). One of the challenges of the discounted cash flow method is to project the future cash flows in a reliable manner, as it is uncertain, how cash flows are realized in future. The discount rate should take into consideration such issues as well as any other uncertainty factors in addition to the time value of money.<sup>762</sup>

It should be noted that the Finnish Tax Administration has explicitly stated in public that one of the frequently used methods by independent parties to value a business in business acquisitions deals is the discounted cash flow method, application of which should be therefore primarily considered also in business restructurings to determine an arm's length compensation for the transfer of a going concern. In such cases, it is also important that the arm's length

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<sup>759</sup> OECD Transfer Pricing Guidelines, 9.68–9.69.

<sup>760</sup> Jaakkola et al. 2012, pp. 313–321.

<sup>761</sup> Kallunki – Niemelä 2007, pp. 109–110; Jaakkola et al. 2012, p. 314.

<sup>762</sup> See Jaakkola et al. 2012, pp. 314–318, where the calculation process using the discounted cash flow method has also been discussed in a more detailed manner. *Time value of money* means in practice that money available today is worth more than the same amount received in future.

compensation shall be determined particularly by comparing the cash flows that the group company would have received by continuing its current business activities with the cash flows that the company is expected to gain after the restructuring.<sup>763</sup> Also, the Finnish Tax Administration referred to the discounted cash flow method in the above-discussed memorandum as an example of other applicable valuation methods to value a business in estate and gift taxation.<sup>764</sup> It must also be observed that the Supreme Administrative Court of Finland has also approved the use of the discounted cash flow method in its ruling regarding transfer pricing. Although the case concerned a controlled transfer of shares between related parties, the court was of the opinion that the discounted cash flow method may also be used for tax purposes, when a market value is determined for an unlisted company, given that sufficient grounds for the used parameters are presented.<sup>765</sup>

Moreover, the OECD Transfer Pricing Guidelines nowadays also state that “the guidance on the use of valuation techniques for transactions involving the transfer of intangibles or rights in intangibles” set out in Chapter VI should also be considered in the transfer pricing of transfers of a going concern.<sup>766</sup> As discussed earlier, the OECD has in Chapter VI expressly mentioned the discounted cash flow method as one example of valuation techniques used by independent parties, which could be particularly useful in the determination of an arm’s length compensation.<sup>767</sup> Now, Chapter IX thus explicitly refers to the potential use of the discounted cash flow method and similar income methods, when an arm’s length compensation is determined for a transfer of a going concern. Hence, taking into consideration the aforesaid observations, there is a strong indication of that the method could — or even should — be used in business restructurings in order to determine an arm’s length remuneration for a transfer of a going concern, provided that sufficient grounds for the use of the method are presented in the transfer pricing documentation.

Although there can be found strong support for the application of the discounted cash flow method for transfer pricing purposes in business restructurings, it has been viewed in the legal literature that also other valuation methods could be used, as the OECD Transfer Pricing Guidelines have not discussed in detail the potential valuation methods applicable to

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<sup>763</sup> Finnish Tax Administration: Transfer Pricing in Business Restructurings; see also Finnish Tax Administration: Client Event 2013, pp. 54–55.

<sup>764</sup> Finnish Tax Administration Memorandum A182/200/2015, p. 31.

<sup>765</sup> KHO 2014:33. See also Penttilä 2015, pp. 133–135; Waal – Pykönen 2014, pp. 557–558.

<sup>766</sup> OECD Transfer Pricing Guidelines, 9.69. This reference was added to the paragraph in 2016, when the OECD made conforming amendments to Chapter IX as a result of the BEPS Project.

<sup>767</sup> See OECD Transfer Pricing Guidelines, 6.153, 6.157.

transfers of a going concern in business restructurings.<sup>768</sup> As mentioned, also the so-called market based methods are used in practice as business valuation methods, and therefore they could be potentially applied to transfers of a going concern in the business restructuring context. The market based methods compare the business to be valued to comparable businesses/companies that have been sold on the market. Another option is to find comparables for the group company in question from listed companies, as the financial reporting data of such companies, e.g. financial statements, is usually readily available. The comparable business sales or listed companies must resemble the business being valued in a sufficient manner. The market based business valuation methods in general use the comparables to calculate ratios of the selling price/market value to certain financial performance factors (such as revenue, gross margin and profit). Such ratios derived from comparables are then used to determine the value for the business in question.<sup>769</sup>

It must be noted that the Finnish Tax Administration advised in the above-discussed memorandum that taxpayers should primarily use comparables, when determining the market value for a business,<sup>770</sup> which therefore indicates that the market based methods — in the transfer pricing context, primarily the CUP method — should be used as a starting point to value a going concern for tax purposes. However, finding sufficiently comparable business acquisitions is not an easy task. In addition, information on comparable listed companies may not be used effectively in the valuation of a business of an unlisted group company. Lastly, in comparison with the cash flow methods, the market based methods do not necessarily take into account sufficiently the risk factors of the business to be valued, which should be reflected in the market value of a business.<sup>771</sup> Therefore, in the majority of the cases, it is likely that the discounted cash flow method would be a better option and would bring a more reliable arm's length result than the market based method, when the value for a going concern is determined in business restructurings.

The determination of the aforementioned net asset value has also been discussed in the legal literature as one possible option for the valuation of a business. However, the use of the net asset value is often limited to situations in which the business is closed down, not continued. As it does not take into account the future cash flow generated by the business, it does not usually provide a correct picture of the market value of a going concern. This is usually

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<sup>768</sup> Penttilä 2015, p. 135.

<sup>769</sup> Jaakkola et al. 2012, pp. 318–321.

<sup>770</sup> Finnish Tax Administration Memorandum A182/200/2015, p. 31.

<sup>771</sup> Jaakkola et al. 2012, p. 321.

the case in situations where intangible assets form the majority of the value of the business.<sup>772</sup>

All in all, in the current legal state, the above-mentioned Finnish Tax Administration's guidance on estate and gift taxation may serve as a starting point for determining an arm's length compensation for transfers of a going concern in business restructurings. Primarily, the market based method should be used in the business valuation for tax purposes, which in the transfer pricing context means the CUP method. As it is likely that the method may not be used that commonly in the determination of a correct market value for a transfer of business, other valuation methods should be applied instead, provided that the end result equals, at least, to the net asset value.

Of great practical relevance is especially the broadly applied discounted cash flow method, use of which has been specifically approved and preferred in transfer pricing by the Finnish Tax Administration, the Supreme Administrative Court of Finland and the OECD Transfer Pricing Guidelines. As a result, it is recommended that the use of the discounted cash flow method is considered carefully in each business restructuring case involving transfer of a going concern, especially if the lack of comparables and/or other factors restrict the valuation on the basis of the CUP method (as well as any other regulated transfer pricing methods) and the calculation principles set out in the Finnish Tax Administration's guidance on estate and gift taxation. It is also likely that the Finnish tax authorities would prefer the use of this method, provided that the method is applied appropriately and specific attention is paid to the written justifications to validate the use of the method.<sup>773</sup> The use of the discounted cash flow methods seems to be acceptable also from the perspective of the arm's length principle, as it is often used by independent parties in business acquisitions.

Similar to the Finnish transfer pricing provisions, the Treasury Regulations do not contain specific sections dealing purely with the transfer pricing aspects of business restructurings and the determination of the arm's length compensation for transfers of a going concern. This means that, as a starting point, the applicability of the specified transfer pricing methods, such as the CUT method, should be first considered. Nevertheless, as discussed above, such methods do not take into account sufficiently the specific features of transfers of a going concern, which leads to that it may be likely that the

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<sup>772</sup> Jaakkola et al. 2012, pp. 313, 321. The Finnish Tax Administration is also of this opinion; see Finnish Tax Administration Memorandum A182/200/2015, pp. 35–36.

<sup>773</sup> The latter requirement is derived from the above-discussed case of the Supreme Administrative Court of Finland, KHO 2014:33 as well as from the OECD Transfer Pricing Guidelines (paragraph 2.9).

application of the specified methods would not result in the best arm's length result in such cases.

However, as was the case in Finland, the U.S. tax authorities have published guidance in other respects containing valuation principles that can be useful, when the arm's length value is determined for transfers of a functioning business unit. The IRS has in recent years focused increasingly on the transfer pricing of cost sharing arrangements, and consequently it has published particular Treasury Regulations regulating methods for the determination of taxable income in connection with such arrangements.<sup>774</sup> While the regulations expressly concern cost sharing arrangements, some of these methods could also be used in determining arm's length compensations for transfers of a going concern (business) in the business restructuring context. As these regulations represent the IRS's current viewpoint on compensations to be paid as 'exit charges', it has been widely regarded in the legal literature that the methods and principles discussed therein may also serve as a guidance in transfer pricing of business restructurings.<sup>775</sup>

This approach is also supported by the fact that the IRS has itself viewed that that the scope of application of the cost sharing regulations must be interpreted broadly: it has stated that "controlled transactions reflecting similar economics, regardless of the type of transaction (such as transfer of intangibles or provision of services), should be valued in accordance with similar principles and methods," which means that "the principles and methods for valuing platform and operating contributions under a CSA [=cost sharing arrangement] may also apply for purposes of determining the best method, which may be an unspecified method, for valuing similar contributions in connection with controlled transfers of intangibles or provisions of services."<sup>776</sup> As transfers of intangible assets play a significant role in business restructurings, the IRS could be willing to apply the principles of the cost sharing regulations from this perspective also to transfers of a going concern occurred in the business restructuring context. In this connection, especially the following three methods regulated in the Treasury Regulations have been regarded applicable to controlled transfers of a going concern: *the income method*, *the acquisition price method* and *the market capitalization method*.<sup>777</sup> As these methods do not concentrate on estimating the value of

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<sup>774</sup> See Treas. Reg. § 1.482-7.

<sup>775</sup> See e.g. Trauman – Van den Bremer 2011, p. 27; Zollo 2011, p. 761; Amerkhail – Granwell 2009, pp. 419–420; Jaakkola et al. 2012, p. 253.

<sup>776</sup> Internal Revenue Bulletin 2012-12. See also Treas. Reg. § 1.482-4(g) and § 1.482-9(m)(3), which contain cross-references to the cost sharing regulations and thus support this view.

<sup>777</sup> Trauman – Van den Bremer 2011, p. 27; Jaakkola et al. 2012, pp. 253–254; Cordova – Mitra – Newman – Reams – Shanda – Shapiro 2012, pp. 55–58; Zollo 2011, p. 777.

separate intangibles, but rather the value of a whole business,<sup>778</sup> they provide useful guidance on how to possibly determine the arm's length value for transfers of a going concern also in business restructurings.

The income method examines in general whether the amount charged in a platform contribution transaction is arm's length by reference to a controlled participant's best realistic alternative to entering into a cost sharing arrangement.<sup>779</sup> The method is applied in situations, in which only one of the controlled parties provides non-routine platform contributions.<sup>780</sup> The method must yield results "consistent with measuring the value of a platform contribution by reference to the future income anticipated to be generated by the resulting cost shared intangibles."<sup>781</sup> The income method basically requires that the controlled party must be in the cost sharing arrangement at least in as good economic position as it would be had it chosen the best realistic alternative. Thus, the method requires that the arm's length compensation must be such an amount that the expected income stream under the cost sharing arrangement equals the present value of the expected income stream under the best realistic alternative.<sup>782</sup> The application of the income method involves the projection of the anticipated future income stream, which must be discounted at the appropriate rate to the present value.<sup>783</sup>

When applying the income method in the business restructuring context, the restructured group company's economic position both before and after the restructuring must be reviewed. The arm's length compensation for the

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<sup>778</sup> Cordova – Mitra – Newman – Reams – Shanda – Shapiro 2012, pp. 56–57; Trauman – Van den Bremer 2011, p. 27.

<sup>779</sup> Treas. Reg. § 1.482-7(g)(4)(i)(A). In a platform contribution transaction, each controlled participant is obligated to make arm's length payments to each controlled participant that provides a platform contribution, see Treas. Reg. § 1.482-7(b)(1)(ii). A platform contribution is "any resource, capability, or right that a controlled participant has developed, maintained, or acquired externally to the intangible development activity (whether prior to or during the course of the CSA [=cost sharing arrangement]) that is reasonably anticipated to contribute to developing cost shared intangibles", see Treas. Reg. § 1.482-7(c)(1).

<sup>780</sup> Treas. Reg. § 1.482-7(g)(4)(i)(D).

<sup>781</sup> Treas. Reg. § 1.482-7(g)(1).

<sup>782</sup> Treas. Reg. § 1.482-7(g)(4)(i). Pursuant to the regulations, the best realistic alternative for the related party, which uses intangibles under a cost sharing arrangement, would be to license such intangibles from an independent party, which bears the entire risk of the development of intangibles. Correspondingly, the best realistic alternative for the related party developing the intangible asset under the cost sharing arrangement would be to bear all the risks with regard to the development of the intangibles and license the intangibles to independent parties; see Treas. Reg. § 1.482-7(g)(4)(i)(A) and Cordova – Mitra – Newman – Reams – Shanda – Shapiro 2012, p. 57.

<sup>783</sup> Treas. Reg. § 1.482-7(g)(4).



transfer of a business (going concern) could be in the above-discussed manner based on the present value of the expected income stream or profits associated with the business. In the determination of such an arm's length compensation, taxpayers should also compare the present value of the expected profits associated with the business had it not been transferred in the restructuring to the present value of the expected profits associated with the business after the business restructuring.<sup>784</sup> In that sense, the expected future income stream under both alternatives must be projected and discounted to the present value. The use of the income method in this manner could be justified by the fact that the income method has been generally regarded as a form of the discounted cash flow method, which is commonly used in business valuation between independent parties.<sup>785</sup> For example, in the U.S. legal literature, the market value of a going concern is considered to be the value of the projected cash flows/profits, which are discounted to a present value using an appropriate discount rate,<sup>786</sup> and therefore the aforementioned approach would be in line with what independent parties would have done under comparable conditions — and ultimately with the arm's length principle.

In this sense, the U.S. law approach is comparable with the approach taken by Finnish law. One difference, nonetheless, can be found; pursuant to the preamble of the cost sharing regulations, while the cash flow projections have been allowed under the Treasury Regulations, the IRS is of the opinion that, “for a number of practical and administrative reasons,” the application of the methods regulated for the cost sharing purposes should preferably be done on the basis of the discounted operating income rather than cash flows.<sup>787</sup>

The application of the income method is dependent on the financial projections and the determination of an appropriate discount rate, which may not be an easy task. In order to apply the method in a reliable manner, it is required that several issues are addressed, such as the correct estimation of the stream of profits over the life of the asset and the impact of the riskiness of the stream on the applicable discount rate.<sup>788</sup> Nevertheless, it should be observed that the IRS favors the use of the income method in practice, as it

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<sup>784</sup> Zollo 2011, p. 761, 769; Trauman – Van den Bremer 2011, p. 27; Jaakkola et al. 2012, p. 253.

<sup>785</sup> Breen 2014, p. 1483; Cordova – Mitra – Newman – Reams – Shanda – Shapiro 2012, p. 56; Femia – Blair 2008, p. 199.

<sup>786</sup> Zollo 2011, p. 769.

<sup>787</sup> 76 Fed. Reg. 80082, 80084.

<sup>788</sup> Blough – Chandler, Subramanian 2011, pp. 2–4; Cordova – Mitra – Newman – Reams – Shanda – Shapiro 2012, p. 57; Zollo 2011, p. 761.

considers it to reflect the controlled party's realistic alternatives better than the other methods.<sup>789</sup>

The acquisition price method, on the other hand, examines whether the amount charged in a platform contribution transaction is arm's length "by reference to the amount charged (the acquisition price) for the stock or asset purchase of an entire organization or portion thereof (the target) in an uncontrolled transaction."<sup>790</sup> In the examination, the method applies the earlier discussed CUT method, and it has been regarded generally as a specific form of the CUT method.<sup>791</sup> The acquisition price method may be thus applied in situations where one of the related parties participating in a cost sharing arrangement with other group companies has immediately prior entering into such an arrangement acquired an unrelated company or business assets thereof. In that case, the original lump sum paid as an acquisition price in the (business) acquisition may provide a reliable measure of the arm's length result in a platform contribution transaction. The arm's length compensation under the method is determined on the basis of the so-called adjusted acquisition price, which is "the acquisition price of the target increased by the value of the target's liabilities on the date of the acquisition, other than liabilities not assumed in the case of an asset purchase, and decreased by the value of the target's tangible property on that date and by the value on that date of any other resources, capabilities, and rights not covered" by the platform contribution transaction(s). Thus, the acquisition price method is commonly used, when substantially all the acquired target's non-routine contributions (basically intangibles) are used in the cost sharing arrangement and consequently covered by a platform contribution transaction.<sup>792</sup>

The potential application of the acquisition price method to transfers of a going concern in the business restructuring context requires that sufficient comparable uncontrolled transactions, i.e. business acquisitions, can be found for the restructuring transaction involving transfer of a business. As it is likely that such comparables cannot easily be found due to the unique features of intangibles, which generally form the majority of the value of a business, the importance of making sufficient adjustments to ensure the comparability

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<sup>789</sup> IRS: Coordinated Issue Paper – Sec. 482 CSA Buy-In Adjustments (LMSB-04-0907-62) (27 September 2007), Section IV. See also Madrian – Weise 2014, p. 790; Heriford – Keates – Lamoureux – Wright 2013, p. 207; Zollo 2011, pp. 761, 777.

<sup>790</sup> Treas. Reg. § 1.482-7(g)(5)(i).

<sup>791</sup> Treas. Reg. § 1.482-7(g)(5)(i); King 2009, p. 36. Alternatively, if the platform contribution transaction(s) in question concern services, the comparable uncontrolled services price method regulated in Treas. Reg. § 1.482-9(c) may be applied instead of the CUT method, see Treas. Reg. § 1.482-7(g)(5)(i). The method is a variation of the CUT method used in service transactions.

<sup>792</sup> Treas. Reg. § 1.482-7(g)(5)(i), § 1.482-7(g)(5)(iii) and § 1.482-7(g)(5)(iv).

cannot be overemphasized. Nevertheless, as the Treasury Regulations require that the related party transaction and the unrelated party business acquisition preceding the cost sharing arrangement must be *contemporaneous* (or otherwise the reliability of the method is reduced),<sup>793</sup> the applicability of the method is further limited especially in business restructurings. It is a difficult task to find information on recently executed unrelated business acquisitions that would also be sufficiently comparable with the restructuring. However, when such information is available, for instance, if the restructured company has bought an independent company or a functioning business unit from an independent company immediately prior to the restructuring and it transfers the same going concern to another group company in the course of a business restructuring, the calculation principles stated above may be used as help in determining an arm's length compensation for such a transfer of a going concern. Nonetheless, also in the legal literature, it has been viewed that the acquisition price method is remarkably limited in its applicability.<sup>794</sup>

The market capitalization method resembles the acquisition price method and is applied to a large extent in a similar manner. The main difference is that, instead of referring to the acquisition price, the market capitalization method evaluates whether the amount charged in a platform contribution transaction is arm's length by reference to "the average market capitalization of a controlled participant (PCT Payee [=platform contribution transaction payee]), whose stock is regularly traded on an established securities market."<sup>795</sup> Pursuant to the method, the arm's length charge for a platform contribution transaction "covering resources, capabilities, and rights" of the platform contribution transaction payee "is equal to the adjusted average market capitalization."<sup>796</sup> The method is particularly applicable to situations where substantially all of a group company's non-routine contributions are involved in the cost sharing arrangement and covered by platform contribution transactions.<sup>797</sup>

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<sup>793</sup> Treas. Reg. § 1.482-7(g)(5)(iv).

<sup>794</sup> See e.g. King 2009, pp. 37, 41.

<sup>795</sup> Treas. Reg. § 1.482-7(g)(6)(i).

<sup>796</sup> Treas. Reg. § 1.482-7(g)(6)(ii). The average market capitalization is the "average of the daily market capitalizations of the PCT Payee [= platform contribution transaction payee] over a period of time beginning 60 days before the date of the PCT [=platform contribution transaction]" and ends on the date of the platform contribution transaction, see Treas. Reg. § 1.482-7(g)(6)(iii). The adjusted average market capitalization is calculated similar to the adjusted acquisition price under the acquisition price method, see Treas. Reg. § 1.482-7(g)(6)(iv).

<sup>797</sup> Treas. Reg. § 1.482-7(g)(6)(i). See also Treas. Reg. § 1.482-7(g)(6)(v), where the factors reducing the reliability of the methods are discussed. Among other things, in situations where "a substantial portion of the PCT Payee's assets consists of tangible property that cannot reliably be valued", the reliability of the method is reduced.

In the business restructuring context, the above mentioned means that the value for a going concern (business) should be derived from the stock exchange value of a controlled business enterprise. The applicability of the market capitalization method basically means that the ownership of valuable intangibles of a group is centralized in one group company.<sup>798</sup> In addition, the Treasury Regulations require that this controlled party is a listed company in the above-mentioned manner. Since these requirements are not nearly always met in business restructurings, the scope of applicability of the method is rather limited in restructurings. Consistent with the acquisition price method, it is generally considered that the market capitalization method may be applied in practice only on rare occasions.<sup>799</sup>

In addition to the aforementioned three methods, the cost sharing regulations regulate also other methods applicable to cost sharing arrangements.<sup>800</sup> However, these methods do not take into account the value of a business as a whole to the same extent, and thus they have not been considered in the legal literature as methods possibly applicable to business restructurings. From the above-discussed three methods, the income method can be regarded as the most suitable method for determining an arm's length compensation for a transfer of a going concern, as the scope of application of the other two methods is extremely limited. In addition, as discussed, the IRS prefers the use of the income method. The arm's length compensation is under the income method based on the forthcoming income streams of a business, which are discounted to a present value using an appropriate discount rate. Hence, the method conforms to what independent parties would commonly do in similar situations, as the discounted cash flow method is in the aforesaid manner a commonly applied method in the business valuation. Therefore, also from the perspective of the arm's length principle, the use of the income method would be the best option.

The U.S approach is to a great degree comparable with the Finnish approach. As it is likely that the traditional, specified transfer pricing methods (most importantly, the CUP/CUT method) do not address in a sufficient manner the specific features of transfers of a going concern, it should be evaluated, how independent parties would determine the value for the transfers of a going concern/business unit under similar conditions. The income based methods usually provide the best results in terms of the arm's length principle, as — in

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<sup>798</sup> Madrian – Weise 2014, p. 787; King 2009, p. 37.

<sup>799</sup> King 2009, p. 41; Femia – Kirmil 2005, p. 13.

<sup>800</sup> See Treas. Reg. § 1.482-7(g) for the full list.

contrast to other alternative methods (such as market based methods<sup>801</sup>) — they are not dependent on finding sufficient comparables for transfers of a going concern, which may be a difficult task. As the income method under the Treasury Regulations is in principle a variation of the discounted cash flow method, which in turn is commonly used by independent parties, it provides an acceptable solution from the perspective of the arm's length principle. Furthermore, as the discounted cash flow method is also frequently used in Finland together with other income based methods and expressly approved by the Finnish Tax Administration and the Supreme Administrative Court of Finland, U.S. and Finnish law are increasingly consistent with each other in this respect.<sup>802</sup>

Hence, the use of the income method/discounted cash flow method should primarily be considered in business restructurings that involve transfers of a going concern. As the existing situations in Finland and the USA allow the use of such valuation methods that are often used in transactions between independent parties, the arm's length principle is followed to a great degree in this regard. In the determination of an arm's length compensation, it is important under both Finnish and U.S. law approaches to compare the present value of the expected profits/cash flows associated with the business had it not been transferred in the restructuring to the present value of the expected profits/cash flows associated with the business after the business restructuring. Nonetheless, the application of the method to business restructurings is not a straightforward task, as it involves the projection of future income streams/cash flows, and an appropriate discount rate must be determined in order to discount the income streams/cash flows to a present value. Therefore, the choice of the method as well as all the parameters and figures in its application must be validated in the transfer pricing documentation in a reliable and thorough manner, or otherwise the tax authorities may be willing to intervene in the arrangement.

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<sup>801</sup> The acquisition price method and the market capitalization method may be regarded as market based methods, as the application thereof relies on comparables, and they are considered specific forms of the CUT method, as stated above.

<sup>802</sup> As discussed, one small difference can be found in this approach: while the IRS has stated that the income method may be applied on the basis of projected cash flows, it prefers the projection of the discounted operating income rather than the former; see 76 Fed. Reg. 80082, 80084.

#### 4.3.6 TERMINATION OR RENEGOTIATION OF EXISTING AGREEMENTS

The termination or renegotiation of an existing arrangement in connection with a business restructuring must primarily be examined from the perspective of whether independent parties would have required a compensation for such a termination or renegotiation under similar circumstances. Such terminations or renegotiations must be reviewed on a case-by-case basis, and therefore there should be no assumption that they will always be compensated at arm's length.<sup>803</sup> As discussed, the question is topical under Finnish and U.S. tax law, while the terminations/renegotiations of existing arrangements likely fall outside the scope of application of the Russian transfer pricing rules.

The OECD Transfer Pricing Guidelines should be taken as the starting point under Finnish law, when evaluating the premature termination or renegotiation of an existing arrangement from the transfer pricing perspective. As mentioned earlier, the guidelines regulate conditions, which should be taken into account, when determining whether an arm's length compensation shall be paid for the termination or renegotiation of an existing agreement. This guidance is also helpful, when an actual amount of the arm's length indemnification is determined for such a termination or renegotiation of existing arrangements. Therefore, when it is concluded in the previously discussed manner that an arm's length compensation must be paid for the premature termination or renegotiation of an agreement, national commercial law (including legislation and case law) may provide primarily helpful insights in this respect, as they may regulate, for example, indemnification rights to which the suffered related party may be entitled.<sup>804</sup> Finnish legislation, case law and any other possible sources of law regulating contractual arrangements as well as specific business activities (if applicable) should be thus examined in order to achieve the arm's length result in a given case.

It was previously discussed that, pursuant to the general principles of Finnish contract law, long-term agreements expire either when an agreement is terminated or when a fixed term has ended. A long-term agreement, which is in nature a fixed-term agreement, cannot thus be terminated before the expiry of the term. On the other hand, agreements in force until further notice may be terminated after a certain period of notice. If a long-term agreement is terminated unlawfully, a suffered party is usually entitled to a compensation in accordance with *the positive interest* of the agreement. The positive interest means that the party, which is in breach of the agreement, must compensate

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<sup>803</sup> See e.g. OECD Transfer Pricing Guidelines, 9.78.

<sup>804</sup> OECD Transfer Pricing Guidelines, 9.79–9.80.

the suffered party for the breach so that the latter party is put into a position, where it would have been had the party in breach complied with the agreement.<sup>805</sup>

From this perspective, if an independent party would receive a compensation for the premature termination of an existing agreement pursuant to the positive interest, it is very likely that such a remuneration based on the positive interest of the agreement should also be paid in a business restructuring, which involves a similar premature termination of an existing agreement under similar conditions. In practice, this means that in a business restructuring it must be reviewed, whether an existing arrangement terminated/re-negotiated prematurely includes an indemnification clause, which would entitle the suffered party to a remuneration in accordance with the positive interest of the agreement in such situations; in case of absence of the indemnification clause, the starting point should thus be that the suffered party should be compensated at arm's length pursuant to the positive interest, if independent parties would be entitled to such a compensation. If the agreement includes an indemnification clause, which entitles the suffered party only to a limited indemnification or no indemnification whatsoever in such cases, it must be examined whether such a clause is arm's length, i.e. whether independent parties would restrict their right to compensation in such situations, as discussed earlier.<sup>806</sup> If the clause is not arm's length, it may be required that the compensation to be paid under the indemnification clause should be adjusted to be in line with the positive interest. In practice, the positive interest could mean that the suffered party could be entitled to, for example, expected profits that would have realized from the agreement had the agreement been in force pursuant to the contractual terms. This view can also be justified by the fact that, by applying this approach, related parties would basically apply the CUP method: the arm's length compensation would in that case conform to what independent parties would have agreed under similar conditions. This would also mean that the arm's length principle would ultimately be followed in such a situation.

On the other hand, the aforesaid Finnish Act on Commercial Representatives and Salesmen forms an example of an act, which contains specific provisions on the premature termination of certain business relations and the compensation thereof. The act may in particular have an impact on business restructurings, which involve changes in the sales activities and functions of a multinational enterprise, and, as a result, existing sales agreements are unlawfully terminated. For example, pursuant to § 28 of the act, if a sales agent loses commissions due to the premature termination of a sales agency

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<sup>805</sup> Norros 2009, pp. 633–634, 644.

<sup>806</sup> OECD Transfer Pricing Guidelines, 9.79, 9.81–9.83.

agreement, it may under certain circumstances be entitled to a compensation, which equals up to one year's agent commissions.<sup>807</sup> Thus, by applying the approach based on the CUP method above, it may be required that related parties should in a business restructuring compensate a group company for the termination of an existing sales agency agreement in accordance with the principles of the Finnish Act on Commercial Representatives and Salesmen, if independent parties would apply the act in comparable situations.<sup>808</sup>

The above-discussed indemnification requirements arising from Finnish contract and commercial law are just examples of how the terminations or renegotiations of existing agreements occurred in the business restructuring context could be indemnified at arm's length in certain circumstances. The OECD Transfer Pricing Guidelines require that the facts and circumstances of each case must always be examined.<sup>809</sup> Therefore, for instance, the type of the agreement as well as the branch of industry may have an impact on whether and to what extent the termination or renegotiation of an existing arrangement should be compensated in a particular case. The most important factor to consider is how independent enterprises would indemnify (if at all) the termination/renegotiation in similar circumstances.<sup>810</sup>

This approach must be taken as the starting point also in the USA. The arm's length standard requires that if the results of the controlled transaction, in this case, terminations or renegotiations of existing arrangements, are in line with the results that would have been realized in a transaction between independent parties under the same circumstances, the controlled transaction meets the requirements of the arm's length standard — and *vice versa*.<sup>811</sup> As was the case in Finland, the U.S. transfer pricing provisions do not contain specific provisions on the determination of arm's length remunerations for the premature terminations or renegotiations of existing arrangements, and therefore answers to the question must be sought from other sources.

As discussed earlier, the provisions of the Uniform Commercial Code, which have been enacted by the states broadly, provide basic contractual principles in commercial transactions, which can be used to validate claims for civil damages in situations where existing agreements have been terminated unlawfully. The Uniform Commercial Code contains provisions according to

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<sup>807</sup> See § 23, § 26 and § 28 of the Act on Commercial Representatives and Salesmen in more detail.

<sup>808</sup> See more about the determination of the so-called residual commission in Saarnilehto – Viljanen 2006, pp. 387–396.

<sup>809</sup> OECD Transfer Pricing Guidelines, 9.78.

<sup>810</sup> See e.g. OECD Transfer Pricing Guidelines, 9.78, 9.80, 9.92; Finnish Tax Administration: Transfer Pricing in Business Restructurings.

<sup>811</sup> See Treas. Reg. § 1.482-1(b)(1).



which the suffered party of a contractual arrangement concerning sale of goods is entitled to damages for the breach of a contract in different ways depending on the nature of the breach.<sup>812</sup> For instance, the code includes provisions as to measuring the seller's damages for non-acceptance or repudiation by the buyer. The general idea in that case is "to put the seller in as good a position as performance would have done."<sup>813</sup> In addition, the general provision of the Uniform Commercial Code, covering all parts of the code (not only the part related to the sales of goods), also states that ultimately "the remedies provided by [the Uniform Commercial Code] must be liberally administered to the end that the aggrieved party may be put in as good a position as if the other party had fully performed."<sup>814</sup>

From the above mentioned, it must be observed that U.S. contract law has thus a concept, which corresponds to the Finnish concept of positive interest of an agreement. The concept is called — in the already discussed manner — *the expectation interest*, and it basically means that a suffered party should be put into as good position as the party would be had the agreement been performed. The concept has been discussed in the legal literature and, more importantly, broadly recognized by the courts.<sup>815</sup>

As it was already previously discussed, perhaps the most important source regulating the expectation interest is the Restatement (Second) of Contracts (1981), as it provides more specific guidance with respect to applying it in practice. Notwithstanding the Restatement is not generally a legally binding source in U.S. law or enacted by states in their legislation, it has a persuasive authority, and therefore it is followed to a large extent by courts in their decision-making.<sup>816</sup> According to the Restatement, expectation interest is a promisee's "interest in having the benefit of his bargain by being put in as good a position as he would have been in had the contract been performed."<sup>817</sup> In a more detailed way, "the injured party has a right to damages based on his expectation interest as measured by (a) the loss in the value to him of the other party's performance caused by its failure or deficiency, plus; (b) any other loss, including incidental or consequential loss, caused by the breach, less; (c) any cost or other loss that he has avoided by not having to perform."<sup>818</sup>

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<sup>812</sup> See e.g. Articles 2-703 and 2-711 of the Uniform Commercial Code (2002).

<sup>813</sup> Article 2-708 of the Uniform Commercial Code (2002).

<sup>814</sup> Article 1-305 of the Uniform Commercial Code (2001).

<sup>815</sup> See e.g. Landgraf – Arnautovic 2015, pp. 321–322; Tongish v. Thomas, 840 P.2d 471 (Kan. 1992); Metro. Prop. & Cas. v. Harper, 168 Or. App. 358 (2000).

<sup>816</sup> As mentioned, courts have also cited to it in their rulings as it they would have cited to legal statutes or codes; see Gutman 2014, p. 118; Klass 2010, p. 46; Maggs 1998, p. 8.

<sup>817</sup> § 344 of the Restatement (Second) of Contracts (1981).

<sup>818</sup> § 347 of the Restatement (Second) of Contracts (1981).

Based on the observations above, it can be stated that, as was the case under Finnish law, if independent parties could be entitled to a remuneration in accordance with the expectation interest for premature terminations or renegotiations of existing agreements, it may be required that a related party is under similar circumstances compensated similarly and put to as good position as it would be had the agreement been followed thoroughly and not terminated/renegotiated prematurely in the business restructuring. In practice, this could mean that the suffered party would be entitled to such expected profits arising from the agreement that would have realized had the agreement been in force in accordance with the contractual terms. This could also be required from the perspective of the CUT method. By taking the discussed approach, related parties would compensate the premature termination (or renegotiation) in a similar way had the termination concerned contractual agreement between independent parties, and thus the parties would comply with the CUT method and meet the requirements of the arm's length standard.

This approach requires that the contractual terms of the terminated arrangement must be reviewed in order to examine whether the agreement also allows paying such an indemnification to the suffered party at arm's length. If the indemnification amount would be smaller than to what expectation interest would entitle the suffered party, such a deviation from the expectation interest should be validated in the transfer pricing documentation by referring to differences, for instance, in the circumstances of the case. Otherwise there might be a risk of that the tax authorities may not consider the indemnification arm's length.

For instance, distribution agreements are usually concluded in the USA for a term of one year. If a distribution agreement is terminated in accordance with one year's notice, the agreement expires and the distributor is not entitled to a remuneration. However, if the distribution agreement is terminated immediately contrary to the termination clause, the distributor is usually entitled to a remuneration in the amount of foregone profits of one year pursuant to the termination and/or indemnification clauses of the agreement.<sup>819</sup> If similar arrangements are terminated in the course of business restructurings under similar conditions, it is likely that a corresponding indemnification should be paid to the suffered related party to meet the requirements of the arm's length standard under Section 482 of the IRC.

It was earlier mentioned that commercial relationships have not been regulated in the USA as extensively as in Europe. For example, in contrast to

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<sup>819</sup> Zollo 2011, p. 771; Wright – Keates 2009, pp. 115–116.

the Finnish legislation, there does not exist federal legislation, which would similarly regulate indemnification rights of sales agents in case of unlawful terminations.<sup>820</sup> That being said, U.S. law provides more detailed provisions for the determination of remunerations for the breach of commercial agreements in general, as can be seen from the aforementioned sources. Nevertheless, the arm's length compensation in case of premature terminations or renegotiations of existing agreements is determined to a great degree in a similar manner under both U.S. and Finnish law. Hence, the question of whether a remuneration should be paid for the termination of an existing commercial agreement shall primarily be examined from the contractual terms of the specific agreement itself and by comparing such terms to contractual terms used commonly by independent parties in similar circumstances.<sup>821</sup> The aforesaid regulations and the concepts — the expectation interest under U.S. law and the positive interest under Finnish law — may serve as guidance in business restructurings and should primarily be applied, if independent parties would be entitled to a compensation in accordance with such regulations and concepts in similar circumstances. As the discussed sources allow the use of this approach, also the arm's length principle is followed efficiently in Finland and the USA.

#### 4.4 ARM'S LENGTH RANGE

When comparable uncontrolled transactions have been found for the related party transaction occurred in a business restructuring, and the application of particular transfer pricing methods or other methods described above have provided information on arm's length prices or margins (for instance, figures on gross margins), an arm's length transfer price for the transfer of something of value occurred in the related party transaction(s) must be determined by using such results and information obtained from comparables. In general, the determination of an arm's length compensation requires that an *arm's length range* is formed on the basis of the results derived from comparable transactions, as usually the application of transfer pricing method produces several results, each of which could be acceptable from the perspective of the arm's length principle. The compensation paid in a related party transaction should fall within the arm's length range so that it could be considered arm's length.<sup>822</sup>

The concept of the arm's length range is recognized under the laws of Russia, Finland and the USA, although the Finnish legislation does not deal with it

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<sup>820</sup> Wise 2010, pp. 4–5.

<sup>821</sup> Amerkhail – Granwell 2009, p. 417.

<sup>822</sup> Jaakkola et al. 2012, p. 283; Hellevig – Usov – Kabakov 2014, p. 220; Kaftannikov 2011, p. 39; Wittendorff 2010a, p. 459.

specifically (in contrast to the Russian and U.S. legislation).<sup>823</sup> The concept is also understood similarly in each of these countries: when an application of (transfer pricing) methods produces several results (i.e. figures), which could be acceptable in terms of the arm's length principle, a compensation is considered arm's length, if it falls within an arm's length range derived from such results.<sup>824</sup>

Pursuant to the U.S. and Finnish approach, as a starting point, all the figures in the arm's length range provide an arm's length result in a particular case, provided that comparables forming the range are in general reliable and highly comparable with the controlled transaction (necessary adjustments have been made to eliminate possible differences) as well as to the same extent comparable with each other. If the degree of comparability of some of the comparable transactions is less in comparison with the others, the range should be narrowed to eliminate such comparables from the range.<sup>825</sup> Furthermore, ordinarily — despite the exclusion of figures having a lesser degree of comparability — some comparability issues still remain and cannot appropriately be adjusted. Therefore, usually statistical tools should be adopted to increase the reliability of the arm's length range and to narrow it correspondingly. The most common statistical method in that case is the so-called *interquartile range* where the arm's length range is limited to the range from the 25th to the 75th percentile of the results (figures) derived from the uncontrolled comparable transactions.<sup>826</sup> As opposed to Finnish and U.S. law, the determination of an arm's length range under the Russian Tax Code is based directly on the interquartile range.<sup>827</sup>

In business restructurings, the above mentioned means that the arm's length compensation paid for transfers of something of value must fall within the arm's length range derived from comparable transactions. In cases, where a business restructuring involves purely transfers of certain tangible/intangible assets, forming an arm's length range in accordance with the principles above may be an easier task when compared to transfers of a going concern. Finding

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<sup>823</sup> The guidance of the OECD Transfer Pricing Guidelines as well as the Finnish Tax Administration Memorandum 1471/37/2007, however, contain provisions, which discuss the arm's length range and basically require the application of the arm's length range also in Finland; see e.g. Finnish Tax Administration Memorandum 1471/37/2007, p. 35.

<sup>824</sup> Article 105.8 of the Tax Code; Finnish Tax Administration Memorandum 1471/37/2007, pp. 35–36; OECD Transfer Pricing Guidelines, 3.55–3.60; Treas. Reg. § 1.482-1(e).

<sup>825</sup> Finnish Tax Administration Memorandum 1471/37/2007, p. 35; OECD Transfer Pricing Guidelines, 3.55–3.56; Treas. Reg. § 1.482-1(e)(1), § 1.482-1(e)(2)(ii).

<sup>826</sup> Finnish Tax Administration Memorandum 1471/37/2007, pp. 35–36; OECD Transfer Pricing Guidelines, 3.56–3.57; Treas. Reg. § 1.482-1(e)(2)(iii).

<sup>827</sup> Article 105.8 of the Tax Code.

two or more comparables for the latter may be a difficult — or even an impossible — task, and therefore usually adjustments to eliminate differences of comparables are usually required, before forming the arm's length range. The interquartile range also naturally narrows the range, and in this way enhances the reliability of the arm's length range. On the other hand, it must also be noted that the national sources acknowledge that the application of a transfer pricing method may on certain occasions produce only a single result, meaning that an arm's length price or margin may only be a certain figure derived from one uncontrolled transaction.<sup>828</sup> Nevertheless, the possibility that an arm's length compensation could be based only on one comparable transaction is rather theoretical especially in business restructurings, as it requires the fulfilment of strict requirements: the comparable transaction must conform to the controlled transaction in its entirety so that all the possible material differences between the transactions have been identified and effects thereof have been eliminated by making appropriate adjustments.<sup>829</sup>

## **4.5 CONCLUSION**

### **4.5.1 CURRENT SITUATION AND *DE LEGE FERENDA* VIEWS ON RUSSIAN, FINNISH AND U.S. TAX LAW**

The challenges of determining arm's length compensations for transfers of something of value occurring in the course of a business restructuring culminate especially in two particular issues. First, it may be troublesome to find appropriate transfer pricing methods for determining arm's length compensations for controlled transactions that involve purely transfers of intangibles or rights in intangible properties. Second, traditional regulated transfer pricing methods cannot effortlessly be applied also to transfers of a going concern.

As discussed, intangible assets usually have unique features and characteristics, which leads to that it may prove to be difficult to find comparables for controlled transactions involving transfers of them. Therefore, regardless of that all the target countries prefer the use of the CUP/CUT method at least to some extent in controlled transactions concerning transfers of intangibles, it is likely that the applicability of the profit-based transfer pricing methods must more often be examined in

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<sup>828</sup> Finnish Tax Administration Memorandum 1471/37/2007, p. 35; OECD Transfer Pricing Guidelines, 3.55; Treas. Reg. § 1.482-1(e)(1).

<sup>829</sup> See e.g. Article 105.8 of the Tax Code and Treas. Reg. § 1.482-1(e)(iii)(A).

business restructurings, if the restructurings involve transfers of intangibles. Although the transactional net margin method/the comparable profits method may in general be applied to transactions involving intangibles under the Tax Code and the OECD Transfer Pricing Guidelines, the profit split method can more effectively be applied to transactions involving purely transfers of intangible assets; the latter acknowledges the unique nature of intangibles and has been considered to be more suitable for direct valuation of intangibles. In contrast to the Russian and the Finnish OECD based approaches, the comparable profits method may, under the U.S. transfer pricing rules, also be applied to the controlled transfers of rights in intangible property on certain occasions. This leads to that the applicability of both profit-based transfer pricing methods should always be considered in cross-border business restructurings under U.S. tax law.

However, amendments to the existing transfer pricing rules and guidance could be considered *de lege ferenda* at least in one respect. As the application of the profit split method usually requires that both parties of a related party transaction make unique and valuable contributions (e.g. use unique and valuable intangibles), it is unclear how the method should be applied to transactions involving purely transfers of intangibles. In such transactions only one party *de facto* makes unique contributions, i.e. transfers unique and valuable intangibles. Therefore, as the method has been considered to bring arm's length results also in transactions involving merely transfers of intangibles, if the CUP/CUT method may not be applied, it should be clarified in the transfer pricing rules, how the method should be applied particularly in such circumstances.

Notwithstanding that at least certain regulated transfer pricing methods may be applied to controlled transfers of intangible assets in the aforementioned manner, it is generally acknowledged that they may not always provide sufficient tools for determining arm's length compensations. It could be the case that independent parties would in comparable situations use other techniques to value intangibles than the regulated transfer pricing methods. Fortunately, pursuant to the laws of the target countries, it is, under certain circumstances, also possible for taxpayers to use other valuation methods than the expressly specified transfer pricing methods. In this connection, especially the income based methods, such as the discounted cash flow method, are of great importance.

The use of the unspecified methods very likely provides a reliable arm's length result, as related parties would, in such cases, follow the same valuation principles that would be used by independent parties in comparable circumstances. The valuation uncertainty in the pricing of the transaction involving transfers of intangibles is thus taken into account in a similar

manner as it would be taken by unrelated parties. Hence, the arm's length principle is also greatly followed, as both related and independent parties may use similar valuation methods. In particular, the income based methods, in which the valuation is based on the calculation of the discounted value of projected future income streams or cash flows and which are often used by independent parties, may be particularly useful in determining an arm's length compensation for transfers of intangibles.

Nonetheless, there are certain concerns about the use of such valuation techniques in practice from the perspective of efficiently complying with the arm's length principle. For the sake of predictability and transparency of the tax treatment, it should be considered whether such methods and the application thereof in transfer pricing should be regulated directly in the national transfer pricing rules. Although the Russian Tax Code contains a mention of the possibility of using such methods, the provisions basically refer to a non-taxation related act, and more detailed provisions of the types of the methods are only covered by particular administrative regulations.

Therefore, especially taking into account that the interpretation of Russian law should primarily be based on legal norms, such a relevant issue should be regulated directly in the Tax Code's provisions. This means that, apart from the aforementioned need to include the possibility to consider transfers of intangibles generally as objects of transfer pricing (not only intellectual properties), it would be of great importance to regulate in the Tax Code *de lege ferenda* on how the arm's length compensations should be determined for transfers of intangible property. Detailed guidance on the application of both the transfer pricing methods (in particular, the profit split method) and the discussed other valuation methods (especially, the income method) should also be provided.

In Finland, the aforementioned concerns are primarily less problematic, as the principles of the OECD Transfer Pricing Guidelines are followed in this respect as such, resulting in that it is acceptable to use other valuation techniques in transfer pricing of intangibles. However, apart from references to income based valuation techniques used by independent parties, the OECD's guidance lacks content in this regard. Therefore, while the OECD's guidance on the regulated transfer pricing methods may be considered sufficient for the purpose of following it as such in the Finnish practice, the guidance on the application of other valuation techniques is very limited. As a consequence, it does not provide necessary tools for applying non-specified methods in practice.<sup>830</sup>

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<sup>830</sup> The OECD provides, however, certain observations on the use of the income methods, see OECD Transfer Pricing Guidelines, 6.158–6.178.

Similarly, although the Treasury Regulations interpreting Section 482 of the IRC explicitly accept the use of unspecified methods, they have not discussed at all the types of methods that could be regarded as unspecified methods. This may cause unnecessary vagueness from the point of view of the arm's length principle, taking into consideration that the Treasury Regulations usually aim to address all topical questions of transfer pricing. Hence, both the Finnish and the U.S. transfer pricing rules would, *de lege ferenda*, need to be amended so that the applicability of the aforementioned valuation techniques in the transfer pricing of intangibles is regulated in a clear manner, providing detailed guidance on the application of such methods in practice.

Furthermore, it must also be observed that the application of the valuation techniques that are frequently used by independent parties is not an easy task. For instance, the income based methods require the prediction of future (net) profits, cash flows or other economic benefits that the intangible asset in question may generate during its lifetime. If the prediction is done in an unreliable manner, or the value is discounted to the present value by using an inaccurate discount rate, it may result in that an arm's length result is not achieved in the given case. Therefore, such methods must always be applied and documented diligently in order to find the most appropriate arm's length compensation for transfers of intangibles and to validate the pricing used in transactions.

As with the controlled transfers of intangibles assets, the valuation of contemporaneous transfers of interrelated assets on an aggregate basis — i.e. as a going concern — may rise questions in business restructurings. The Finnish and U.S. transfer pricing rules do not contain explicit regulations as regards transfer pricing of a going concern in the business restructuring context. Hence, the use of the regulated transfer pricing methods should be considered as a starting point, although they are unlikely to provide the best arm's length results in business valuation. The arm's length principle, on the other hand, requires that if unrelated parties would use other valuation techniques in comparable situations, related parties should correspondingly use such techniques to achieve the arm's length result in a given case.

The OECD's guidance is primarily followed in this respect in Finland, which has also been confirmed by the Finnish Tax Administration and the Supreme Administrative Court. While both the OECD and national sources generally refer to valuation techniques that independent parties would apply in comparable circumstances, i.e. in business acquisitions, they have not regulated such methods and the application thereof in detail. The OECD Transfer Pricing Guidelines refer in this connection to the potential use of the unspecified methods used in the valuation of intangibles (i.e. income based methods, such as the discounted cash flow method); the Finnish sources have



also expressly mentioned the possibility to use the discounted cash flow method in transfer pricing of transfers of a going concern.

From this perspective, it seems that at least the income based methods, in particular the discounted cash flow method, may be considered reliable methods in the determination of arm's length compensations for transfers of a going concern, as they are also used by independent parties in similar situations. However, due to the lack of detailed guidance, it is unclear whether tax authorities set other requirements for their use in transfer pricing in practice. Furthermore, it is ambiguous, to what extent other valuation techniques used by independent parties in business valuations may be applied in business restructurings in Finland. Hence, although the existing situation allows the compliance with the arm's length principle, further guidance to address the aforesaid concerns is required to bring more clarity to the question.

Similarly, in the USA, the previously discussed methods used specifically in cost sharing arrangements may, by expansive interpretation allowed by the IRS, be used in determining the arm's length value for transfers of a going concern. From the discussed methods, the income method can be regarded as the most suitable. In addition, as mentioned, the IRS also itself prefers the use of it. Under the income method, the arm's length compensation is based on the forthcoming income streams of a business, which are discounted to a present value using an appropriate discount rate. Thus, in this sense, the U.S. approach conforms with the Finnish approach to a great degree, and the arm's length principle is thus followed efficiently.

Nevertheless, the same uncertainty factors that are present in Finnish transfer pricing in this respect come up with the transfer pricing of transfers of a going concern in the USA — and may be even more problematic there. As the detailed guidance for the application of the unspecified methods to controlled transfers of a going concern is missing, this may cause interpretive problems for taxpayers. In addition, the applicability of the discussed unspecified methods to business restructurings is based in the aforementioned sense on the broad interpretation of the said Treasury Regulations and the IRS's viewpoint. The current approach may thus cause unnecessary uncertainty for the compliance with the arm's length principle. Although the requirement to follow valuation methods that independent parties would use in comparable situations may arise already from the principle as such, amendments to the existing situation are needed. Hence, for the sake of clarity and transparency, the use of such methods — in particular, the income method — should be regulated *de lege ferenda* in the Treasury Regulations in a concrete and detailed manner, paying attention also to potential issues that may arise in the business restructuring context.

Despite that the current provisions in Finland and the USA may to some extent lack the clarifying content and guidance, taxpayers may nonetheless achieve the arm's length result, at present, by invoking such regulations and guidance. As those sources provide, at least by interpretation, certain measures (such as the above-discussed income based methods) to value transfers of bundles of assets (going concerns) as a whole, and are also commonly applied by independent parties in similar situations, related parties may in the end be put in a similar position as independent parties. For instance, related parties may, in the situation under discussion, use the discounted cash flow method that is a frequently applied method in business valuation. Quite the contrary, as the existing Russian provisions do not provide similar tools for the aggregation of related party transaction in a corresponding manner, the requirements of the arm's length principle are not necessarily met efficiently, if independent parties would in comparable situations value such asset transfers on an aggregate basis.

Lastly, the determination of arm's length compensations for premature terminations or renegotiations of agreements is not regulated in Finland and the USA in detail either. The OECD Transfer Pricing Guidelines contain general conditions, which should be taken into account, when determining whether an arm's length compensation should be paid for the termination or renegotiation of an existing agreement and — more importantly — how to determine such a compensation. Based on guidance, *inter alia*, national commercial law, case law and any other applicable sources of law regulating contractual arrangements, indemnification rights and specific business activities should be examined in this connection in Finland. This approach must be taken as the starting point also in the USA. Although similar express references to the principles of specific legislation and case law are missing from the Treasury Regulations, the arm's length standard itself ultimately requires that the results of the controlled transaction — in this case, terminations or renegotiations of existing arrangements — should be in line with the results that would have been realized had the transaction occurred between independent parties.

Despite the fact that the current provisions and guidance of the Finnish and U.S. transfer pricing rules may not be considered that detailed in this regard, they nevertheless make possible for companies to achieve the arm's length result. The provisions and rules start with the assumption that the termination or renegotiation of an existing arrangement occurring in the course of a business restructuring must ultimately be examined from the perspective of whether independent parties would have required a compensation for such a termination or renegotiation under similar circumstances and, if so, on what terms. This means that the examination must in the end be done on a case-by-case basis, and that there cannot be a presumption that a remuneration should always be paid. This approach fulfils the requirements of the arm's length

principle efficiently, as independent parties would not require or be entitled to a remuneration in all cases, where existing arrangements are renegotiated or terminated.

As the prevailing provisions and other guidance leave room for such a case-by-case analysis and require that taxpayers should take into account the specifics of each given case, there is no need for, at least, major improvements to the existing rules in this respect. For instance, it may be an impossible task to provide an exhaustive and all-embracing transfer pricing guidance as regards the determination of arm's length compensations for premature terminations or renegotiations of arrangements that could be applied in different scenarios consistently. As mentioned, the need for the compensation may vary on a case-by-case basis, and especially the OECD Transfer Pricing Guidelines seem to take into account all different factors that may have impact in such cases.

Nonetheless, as the current situation in the USA is based on the interpretation of the arm's length standard, there is a need to have certain issues regulated *de lege ferenda* in the Treasury Regulations to avoid uncertainty. For the sake of clarity, the Treasury Regulations could have general regulations highlighting the importance of reviewing terminations and renegotiations of existing agreements in the transfer pricing analysis of related party transactions. Moreover, similar to the OECD Transfer Pricing Guidelines, general references to commercial law and other sources of law potentially regulating indemnification rights in this connection could be considered.

#### **4.5.2 ANALYSIS FROM THE PERSPECTIVE OF THE ARM'S LENGTH PRINCIPLE**

Domestic transfer pricing rules often provide specific transfer pricing methods for the determination of arm's length compensations that are directly or largely consistent with the transfer pricing methods of the OECD Transfer Pricing Guidelines. As the guidelines provide broadly accepted measures that could be used in complying with the arm's length principle,<sup>831</sup> the approach can be justified as a starting point. However, while such regulated transfer pricing methods may in certain situations prove to be useful, they may not always provide the necessary tools for achieving the best possible arm's length result. In order to follow the arm's length principle efficiently, it is therefore of great importance that domestic transfer pricing rules do not rely solely on such transfer pricing methods.

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<sup>831</sup> See e.g. Calderón 2007, pp. 4–5; Lubic – Gelin – Ossard-Quintaine 2014, pp. 70–71.

The analysis of the target countries' current approaches to the determination of arm's length compensations in the business restructuring context raises a few specific questions from the perspective of complying with the arm's length principle. While the arm's length compensation may, quite easily, be determined for transfers of tangible assets in business restructurings by using the regulated transfer pricing methods, particularly transfers of intangible assets or a going concern require specific attention.

In general, countries seem to prefer, in one way or another, the use of the CUP/CUT method.<sup>832</sup> This approach can be validated also from the perspective of the arm's length principle, as its ultimate aim is to find transactions comparable to the related party transaction. If such comparables can be found, or reasonable adjustments to eliminate potential material differences made, it usually enables the best possible arm's length result. Therefore, in order to comply with the arm's length principle, the applicability of the method should be regulated in domestic transfer pricing rules and generally be considered first also in business restructurings, before reviewing other methods.

However, on the basis of observations arising out of this study, the potential applicability of the CUP/CUT method seems to be very restricted in the business restructuring context. Apart from transfers of tangible assets (where also other traditional transfer pricing methods, such as the resale price and cost plus methods, seem to provide arm's length results), it can poorly be applied to transfers of other forms of something of value. This is usually due to the fact that no comparables can be found and/or potential material differences eliminated to validate the use of the method. The inappropriate or incorrect application of the method would, in the end, be contrary to the arm's length principle.

As evidenced by this research, when an arm's length compensation is determined for a transfer of intangibles, only few of the regulated transfer pricing methods seem to be suitable for direct valuation of intangibles. Intangible assets are often unique, resulting in that comparable transactions are hard or impossible to find, even if necessary adjustments are made to eliminate possible material differences. If the CUP/CUT method may not be applied, the profit-based transfer pricing methods are usually considered. In particular, the application of the profit split method may produce good arm's length results.

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<sup>832</sup> Article 105.7 of the Tax Code; OECD Transfer Pricing Guidelines, 2.3, 6.137 and 6.146; Treas. Reg. § 1.482-1(c)(2)(i).

One of the main advantages of the profit split method is that it does not rely on finding exact comparables for the controlled transaction in comparison with other methods. Thus, it may be used in transactions that involve unique intangibles, although no exact or sufficient comparables can be found for such intangibles. As companies may, in this way, tackle the challenges that may arise from the application of other transfer pricing methods, it is important that domestic transfer pricing rules acknowledge the possibility to use the method. Otherwise, the arm's length principle may not necessarily be followed efficiently — in the worst-case scenario, such transfer pricing rules can be considered inconsistent with the arm's length principle.

Although, of the regulated transfer pricing methods, the profit split method thus seems to be the most appropriate option to value transfers of intangibles, its application may cause uncertainty in certain circumstances. It may be questioned whether the method can bring the best arm's length result in such related party transactions where *solely* intangibles or rights in intangibles are transferred between controlled parties.

As discussed, the application of the profit split method generally requires that both parties of a related party transaction make unique and valuable contributions (e.g. use unique and valuable intangibles). Especially in business restructurings, this question is of great relevance. While such transactions, where both parties make unique and valuable contributions, may be conducted in business restructurings after the execution of the restructuring (e.g. licensing arrangements), the transfers of intangibles that occur during a business restructuring usually involve that only one party, the restructured entity, makes unique contributions, i.e. transfers unique and valuable intangibles. Consequently, it should be clarified in domestic transfer pricing rules, how the method should particularly be applied in such circumstances. It seems that domestic rules remain usually silent in this respect, as was the case in the target countries, which is problematic from the point of view of the arm's length principle. In business restructurings, this may result in obscurity on how the method should be applied to such transfers of intangible properties that occur during a business restructuring. Such unclarity should be avoided to ensure the compliance with the arm's length principle.

Moreover, on the basis of the above mentioned, it is alarming that the arm's length principle may not always be complied with efficiently — or at all — by applying the regulated transfer pricing methods. Such methods are specifically regulated in domestic transfer pricing rules and the OECD Transfer Pricing Guidelines for the purpose of providing necessary tools for the determination of arm's length compensations. The lack of or unclear content may lead to that such methods are not helpful in the determination of the arm's length compensations to the extent required. In consequence, this may, in the worst-case scenario, jeopardize the compliance with the arm's length principle.

From the perspective of the arm's length principle, it is thus important that also other valuation methods and techniques than specifically regulated transfer pricing methods may be used in the determination of arm's length compensations, especially, for transfers of intangibles. Such a possibility could be based, *inter alia*, on domestic transfer pricing provisions (as in Russia and the USA) or directly on the OECD Transfer Pricing Guidelines (as in Finland).

The use of unspecified methods is likely to produce a reliable arm's length result, if the same valuation principles would be used by independent parties in similar circumstances. The valuation uncertainty arising out of the pricing of the transaction involving transfers of intangibles is thus taken into account in a similar manner as it would be taken by unrelated parties. Hence, the arm's length principle may also be followed efficiently, as both related and independent parties may, ultimately, use similar valuation methods. Particularly, the income based methods, in which the valuation is based on the calculation of the discounted value of projected future income streams or cash flows, may be useful in determining arm's length compensations for transfers of intangibles. As such methods are often used by independent parties, it is likely that by using them the arm's length principle is followed efficiently, provided that any of the regulated transfer pricing methods may not be applied in a given case.

Nevertheless, certain problematic issues arise out of the application of such methods in transfer pricing. First, while domestic transfer pricing sources may acknowledge the possibility of using such valuation techniques, the guidance on the application thereof is very limited. For instance, the OECD Transfer Pricing Guidelines mention only income based methods as an example of valuation techniques that could be considered in the valuation of intangibles in related party transactions. In the U.S. Treasury Regulations, the types of methods that could be regarded as unspecified methods are not discussed at all.<sup>833</sup> As a result, necessary tools for applying such non-specified methods in practice are not usually provided in a sufficient manner. This causes unnecessary vagueness from the point of view of the arm's length principle, when also taking into account the extent to which the regulated transfer pricing methods are usually dealt with in transfer pricing rules.

Second, while such other valuation techniques may be used in corporate finance to determine the fair value of intangible properties generally, the fair value standard and the arm's length standard are ultimately two distinct

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<sup>833</sup> Similar thoughts have been expressed in Brauner 2008, pp. 120–122.

valuation standards. The standards have different objectives and premises.<sup>834</sup> Therefore, such principal differences should be taken into account, when other valuation methods than the regulated transfer pricing methods are applied in the transfer pricing context. It may be required that appropriate modifications are made to such methods before applying them in the determination of arm's length compensations.<sup>835</sup> In the current situation, such issues have not usually been dealt with in domestic transfer pricing rules, which may be troublesome from the perspective of the arm's length principle; for ensuring the efficient compliance with the principle, certain measures need to be taken.

Third, it must be observed that the application of the unspecified valuation techniques is not, in the end, an easy task even if the aforementioned observations have been acknowledged in transfer pricing rules. For instance, the income based methods require the prediction of future (net) profits, cash flows or other economic benefits the intangible asset in question may generate during its lifetime. If the prediction is done in an unreliable manner or the value is discounted to the present value by using an inaccurate discount rate, it may lead to an arm's length result not being achieved in the given case. Therefore, such methods must be applied diligently in order to find the most appropriate arm's length compensation for transfers of intangibles and to validate the pricing used in the transaction. Even then, it may be uncertain whether tax authorities consider the determined value arm's length.

The second question that is of great relevance in transfer pricing of business restructurings in this respect relates to transfers of a going concern. As mentioned, specific domestic legislation rarely regulates directly the possibility of considering business restructurings as transfers of a going concern for transfer pricing purposes. In some countries, like Finland, the OECD Transfer Pricing Guidelines may in practice be used as such; alternatively, domestic transfer pricing rules may allow the aggregation of related party transactions to the extent that also transfers of a going concern may be examined in business restructurings on an aggregate basis (e.g. the approach in the USA). As domestic transfer pricing rules do not primarily contain explicit regulations as regards transfer pricing of a going concern in the business restructuring context, the use of the regulated transfer pricing methods should primarily be considered.

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<sup>834</sup> The arm's length value is determined on a pre-tax basis, while the valuation techniques used to value the fair value may be determined on a post-tax basis. Furthermore, the arm's length principle is applied to an actual transaction, while this is not necessarily the case when the fair value is determined; see Wittendorff 2010b, pp. 325–326.

<sup>835</sup> As the arm's length principle requires a two-sided valuation, this should be taken as a starting point, when such valuation techniques are applied, see e.g. Lagarden 2014 pp. 340–341.

Based on experiences of the examined target countries, the regulated transfer pricing methods do not provide the necessary tools for the determination of the arm's length compensation for a transfer of a going concern. As transfers of a going concern may comprise several contemporaneous transfers of different kinds of assets, risks and functions, it is unlikely that comparables can be found for such a transfer to validate the use of the CUP/CUT method. In addition, the other regulated transfer pricing methods do not necessarily take into account all the valuable elements that may be involved in a transfer of a functioning business unit. It is likely that independent parties would, in such situations, use specific business valuation methods that analyze all the separate transfers of something of value as a whole. Therefore, from the perspective of the arm's length principle, the application of such methods should also be considered in determining transfer prices for transfers of a going concern.

The aforementioned approach has also been adopted in some countries. The Finnish transfer pricing sources as well as the OECD Transfer Pricing Guidelines generally refer to valuation techniques that independent parties would apply in comparable circumstances, i.e. in business acquisitions. In particular, this approach allows related parties to use income based methods, especially the discounted cash flow method, that is generally used in business valuation by independent parties. From this perspective, it thus seems that at least the income based methods, and in particular the discounted cash flow method, may be considered reliable methods in the determination of arm's length compensations for transfers of a going concern, at least so far as they would also be used by unrelated parties in similar situations. However, certain concerns also arise out of this approach in the current situation.

First, it is extremely problematic from the perspective of the arm's length principle, if the possibility of using such valuation methods is solely based on a broad interpretation of existing transfer pricing rules.<sup>836</sup> The efficient application of the arm's length principle requires that such a possibility is regulated more directly, preferably, in the main domestic transfer pricing sources. If transfer pricing rules just remain silent in this respect, the unclarity and uncertainty of the tax treatment may result in that the arm's length principle is not efficiently followed.

Second, although transfer pricing regulations would acknowledge the possibility of using some unspecified methods, they usually lack content in terms of the application of such methods specifically to transfers of a going concern. Transfer pricing rules may, for instance, just contain a general reference to valuation techniques used in business and intangible asset

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<sup>836</sup> As is the case in the USA.



valuation that could be useful in this respect (the approach in Finland). If the detailed guidance for the application of the unspecified methods to controlled transfers of a going concern is missing in (domestic) transfer pricing rules, this may cause interpretive problems for taxpayers. It may be ambiguous, for example, what are the “unspecified methods”, should certain methods be preferred over other methods and how such methods should be applied in the transfer pricing context for the purpose of achieving the best arm’s length result.

Thus, while companies may, by invoking national transfer pricing regulations and guidance, be able to value transfers of bundles of assets (a going concern) as a whole and therefore apply other valuation methods than the regulated transfer pricing methods, it is not always crystal clear whether and how companies may achieve the arm’s length result by using them. In consequence, the arm’s length principle may not necessarily be followed efficiently. For the sake of clarity and transparency, the use of such methods in transfer pricing should be regulated in a detailed and consistent manner.

Third, the same uncertainty factors that relate to determining arm’s length compensations for transfers of intangible assets are also topical in this context. As such valuation methods and techniques — such as the discounted cash flow method — are initially developed for different kind of use (e.g. determining fair value in corporate finance), principal differences should be taken into account, when other valuation methods than the regulated transfer pricing methods are applied in the transfer pricing context. Using such methods in transfer pricing, without making any modifications, may result in that a compensation paid in a controlled party transaction is not necessarily consistent with the arm’s length principle.

Furthermore, the application of income based methods to business restructurings is never a straightforward task, as it involves the projection of future income streams/cash flows, and an appropriate discount rate must be determined in order to discount the income streams/cash flows to a present value. Therefore, the choice of the method as well as all the parameters and assumptions related to its application must carefully be reviewed in order to achieve the arm’s length result. If the prediction of income/cash flow is done in an unreliable manner or the value is discounted to the present value by using an inaccurate discount rate, the end result may be incompatible with the arm’s length standard.

Lastly, when the determination of arm’s length compensations for premature terminations or renegotiations of agreements is based on the examination of whether independent parties would have required a compensation for such a termination or renegotiation (and on what terms), the arm’s length principle seems to be followed efficiently. As independent parties may not always

require or be entitled to such a compensation or indemnification, the examination should be done, in the end, on a case-by-case basis. If transfer pricing rules leave room for case-by-case analysis and require that taxpayers should take into account the specifics of each given case, such rules also likely comply with the arm's length principle.

#### **4.5.3 OECD TRANSFER PRICING GUIDELINES — A STANDARD TO BE FOLLOWED UNIVERSALLY?**

As was the case with the question of objects of transfer pricing in business restructurings, the OECD Transfer Pricing Guidelines seem to provide, at first sight, necessary guidance for complying with the arm's length principle when determining compensations for such objects. Apart from containing specific provisions in this regard, Chapter IX of the OECD Transfer Pricing comprises several references to other chapters of the guidelines, containing specific guidance on the application of the regulated transfer pricing methods as well as information on other valuation techniques.<sup>837</sup> Taking into consideration the importance of the OECD Transfer Pricing Guidelines in international tax law,<sup>838</sup> it should be reviewed whether the guidelines provide adequate and efficient tools for determining arm's length compensations for transfers of something of value in the context of business restructurings. Especially of great interest is to examine whether the existing guidance should, in a consistent manner, be adopted to domestic transfer pricing legislation and regulations.

As discussed above, arm's length prices may be determined for transfers of something of value by specific transfer pricing methods and/or by other unspecified valuation techniques. The OECD Transfer Pricing Guidelines acknowledge both options in the aforementioned manner. They regulate specific transfer pricing methods that take into account the features of different kinds of related party transactions (e.g. whether services are provided or tangible assets/intangibles are transferred). In addition, they deal with the possibility of using other valuation methods and techniques than the regulated transfer pricing methods. Such other methods may be used instead of using the regulated transfer pricing methods, if they provide the most appropriate and reliable result in terms of the arm's length principle in a given case.<sup>839</sup> As the OECD Transfer Pricing Guidelines acknowledge in this sense both approaches, and specifically allow the use of other valuation methods for the

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<sup>837</sup> See e.g. OECD Transfer Pricing Guidelines, 9.53, 9.56 and 9.68–9.69.

<sup>838</sup> See e.g. Calderón 2007, pp. 4–5.

<sup>839</sup> OECD Transfer Pricing Guidelines, 2.9.

purpose of achieving the best arm's length result, the guidelines primarily seem to have an efficient approach to complying with the arm's length principle.

Also, the OECD Transfer Pricing Guidelines prefer the use of the CUP method.<sup>840</sup> As it was discussed in the previous chapter, the CUP method usually brings the best arm's length result, if comparables can be found for the related party transaction in question. In order to comply with the arm's length principle, the transfer pricing rules should thus regulate the potential use of the method. As the OECD Transfer Pricing Guidelines have this covered, and the application of the method should hence be considered first also in business restructurings, the guidelines seem to provide an arm's length approach to business restructurings also in this respect.

Furthermore, the OECD's approach seems to be in line with the arm's length principle, when the determination of arm's length compensations for transfers of something of value in the business restructuring context is preliminarily examined. The application of certain transfer pricing methods provided in the guidelines — the CUP, resale price or cost plus methods — usually allow companies to determine arm's length prices for transfers of goods, machinery, inventory or other tangible assets occurring in business restructurings.<sup>841</sup> Moreover, the OECD regards the CUP and profit split methods as well as other valuation techniques as suitable methods for the determination of the arm's length compensations for transfers of intangibles.<sup>842</sup> As discussed above, the profit split method does not rely on finding comparables as much as the other regulated methods, which is why its use might also be more practical. In cases, where the method cannot be applied, other unspecified valuation techniques should be considered in determining arm's length compensations, as such methods would likely be applied in transactions between unrelated parties. Thus, from this perspective, the OECD Transfer Pricing Guidelines' approach seem to lead to good results in terms of the arm's length principle, when transfer prices are determined for transfers of tangible and/or intangible assets in the business restructuring context.

Correspondingly, the OECD Transfer Pricing Guidelines recommend considering the use of unspecified valuation techniques, such as the valuation methods used in acquisition deals by independent parties, when determining the arm's length compensation for a transfer of a going concern. This approach allows the use of the income based methods that are based on the calculation

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<sup>840</sup> OECD Transfer Pricing Guidelines, 2.3, 6.137 and 6.146.

<sup>841</sup> See e.g. OECD Transfer Pricing Guidelines, 9.52.

<sup>842</sup> OECD Transfer Pricing Guidelines, 6.145.

of the discounted value of future income streams or cash flows,<sup>843</sup> which have been regarded as appropriate measures for determining arm's length compensations for transfers of a going concern. Finally, the guidelines also recognize the possibility of examining the premature terminations or renegotiations of existing arrangements on a case-by-case basis (i.e. whether an indemnification needs to be paid and, if so, on what terms),<sup>844</sup> which seems to be the best approach from the perspective of the arm's length principle.

Hence, on the aforementioned grounds, the guidelines seem to provide efficient tools for complying with the arm's length principle, when compensations are determined for typical transfers of assets/something of value that occur in business restructurings. Could the OECD Transfer Pricing Guidelines thus be considered as an international transfer pricing standard that could and should be adopted to domestic transfer pricing rules in this regard?

It seems that at least few issues, nevertheless, speak against such a view. First, the question regarding the application of the profit split method in the determination of arm's length compensations for transfers of intangible assets is still to some extent ambiguous. Regardless of that the profit split method can be applied to transactions involving purely transfers of intangible assets pursuant to the OECD Transfer Pricing Guidelines,<sup>845</sup> it is somewhat unclear how the method should be applied in such situations in practice. As the application of the profit split method primarily requires that both parties to a related party transaction make unique and valuable contributions (e.g. use unique and valuable intangibles), it is unclear how the method should be applied to transactions involving solely transfers of intangibles or rights in intangibles. While such transactions, where both parties make unique and valuable contributions, may be conducted in business restructurings after the execution of the restructuring (e.g. licensing arrangements), the transfers of intangibles that occur during a business restructuring usually involve that only one party, the restructured entity, makes unique contributions, i.e. transfers unique intangibles. Consequently, it should be clarified in the guidelines, how the method should be applied particularly in such circumstances.

However, as discussed, the OECD is currently updating the guidance in relation to the application of the profit split method. Pursuant to the OECD's discussion draft on the revised guidance on profit splits, the application of the profit split method is still emphasized in transactions where both parties make unique and valuable contributions (e.g. contribute unique and valuable

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<sup>843</sup> OECD Transfer Pricing Guidelines, 6.153, 9.68–9.69.

<sup>844</sup> OECD Transfer Pricing Guidelines, 9.75–9.97.

<sup>845</sup> OECD Transfer Pricing Guidelines, 6.145, 6.148–6.149.

intangibles) to the related party transaction.<sup>846</sup> The OECD seems to be willing to limit the inappropriate use of the profit split method in transactions where only one related party makes such contributions.

The OECD is of the opinion that a more reliable arm's length result in such cases may be usually achieved by making adjustments to the available comparables (although they might be imperfect) rather than applying the profit split method inappropriately.<sup>847</sup> Nevertheless, when such adjustments cannot be made, and thus appropriate comparables cannot be found, the use of the profit split method may still be considered in the transfer pricing of intangibles; the OECD has repeated its view on the possibility of using the method in controlled transactions involving merely transfers of intangibles.<sup>848</sup> This causes unclarity, as the OECD has not provided any concrete guidance on the use of the method in the latter situations, although it is willing to limit the use of it in the above-mentioned manner. Hence, the question seems to remain unanswered even after the proposed amendments.

Second, the OECD Transfer Pricing Guidelines currently provide insufficient guidance with regard to the use of other valuation techniques in the determination of arm's length compensations for transfers of intangible assets. Although the guidelines regard other valuation techniques as useful tools where reliable comparables cannot be found for the controlled transfer of intangible assets,<sup>849</sup> and in this sense follow the arm's length principle, the regulated guidance lacks the necessary content for their successful application in practice. This can result in that the arm's length principle may not ultimately be followed efficiently. Certain areas of concern are, however, provided for the use of income based methods based on the discounted value of projected cash flows. It is stated, *inter alia*, that when applying such methods, specific attention must be paid on the accuracy of financial projections and on the choice of appropriate discount rate, as even small changes in the taken assumptions or the applied discount rate may result in large differences in the value of the intangible asset.<sup>850</sup> Nevertheless, such

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<sup>846</sup> OECD Public Discussion Draft on Revised Guidance on Profit Splits, 6 and 14. See also OECD BEPS Actions 8–10, pp. 55–61.

<sup>847</sup> OECD Public Discussion Draft on Revised Guidance on Profit Splits, 14; OECD BEPS Actions 8–10, pp. 60–61.

<sup>848</sup> OECD Public Discussion Draft on Revised Guidance on Profit Splits, 18.

<sup>849</sup> OECD Transfer Pricing Guidelines, 6.153.

<sup>850</sup> See OECD Transfer Pricing Guidelines, 6.158–6.178. It should, however, be noted that the guidelines have introduced certain measures in relation to the valuation of the so-called hard-to-value intangibles, which should be mentioned in this connection. If a related party transaction involves transfers of intangibles for which no reliable comparables exist at the time of their transfer, and the projections of future cash flows or income that is expected to be derived from such intangibles is highly uncertain at

observations just highlight the difficulty of using income based methods in a correct manner, and a more detailed guidance on their use in transfer pricing is entirely missing.

Moreover, the guidelines seem to provide quite extensive restrictions for the use of such unspecified valuation methods. The valuation techniques must be used in a manner that is in line with the arm's length principle and other guidance of the OECD Transfer Pricing Guidelines. However, except for general references to other chapters of the guidelines, no additional guidance for the satisfaction of this requirement is provided.<sup>851</sup> In addition, the guidelines state that the valuation assumptions used in accounting may lead to a result that is not acceptable in transfer pricing, being thus also inconsistent with the arm's length principle. Pursuant to the guidelines, "caution should therefore be exercised in accepting valuations performed for accounting purposes as necessarily reflecting arm's length prices or values for transfer pricing purposes without a thorough examination of the underlying assumptions."<sup>852</sup> Finally, the guidelines even state that "it is not the intention of these Guidelines to set out a comprehensive summary of the valuation techniques utilised by valuation professionals."<sup>853</sup>

While providing a broad and exhaustive presentation of potential valuation techniques that could be used in transfer pricing of intangibles may be an impossible task, a more concrete guidance on the application thereof in transfer pricing is ultimately needed. The existing provisions require that the special circumstances and nature of transfer pricing need to be taken into consideration in the application of such methods, which is justified from the perspective of the arm's length principle. However, the content of the guidelines in this regard is vague and insufficient, resulting in that it is uncertain when and how the arm's length result, that is consistent with the principles of the guidelines, may be achieved by using such valuation techniques. It is unclear, for instance, what kinds of modifications are required to be made to such methods before applying them in the transfer pricing

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the time of the transfer, such intangibles may be considered hard-to-value intangibles. If there are differences between the values of such intangibles when the projections are made (*ex ante*) and when the actual outcomes of the transaction are known (*ex post*), tax authorities may be entitled to make adjustments to the *ex ante* pricing, if the projections were based on unreliable information and events and risks that caused the different outcome should have been foreseen at the time of projections; see OECD Transfer Pricing Guidelines, 6.186–6.195. Nevertheless, this guidance is not helpful when the valuation of such intangibles is determined *during* a business restructuring, which ultimately is the key question in this research.

<sup>851</sup> OECD Transfer Pricing Guidelines, 6.154.

<sup>852</sup> OECD Transfer Pricing Guidelines, 6.155.

<sup>853</sup> OECD Transfer Pricing Guidelines, 6.156.

context, i.e. in the determination of arm's length compensations. In the current situation, as such issues have not been dealt with sufficiently, this is troublesome also from the perspective of the arm's length principle. For the sake of ensuring the efficient compliance with the principle, certain measures thus need to be taken.

Third, it can also be questioned whether the OECD provides sufficient guidance on the determination of the arm's length compensations for transfers of a going concern in the business restructuring context. Although the OECD defines the concept in a definite manner and allows the use of valuation techniques in such transfers, it does not regulate clearly when the examination of contemporaneous transfers of assets, risks and functions should be analyzed on an aggregate basis. As discussed, it mentions that "the determination of the arm's length compensation for a transfer of an ongoing concern *does not necessarily* amount to the sum of the separate valuation" and that "valuation of those [contemporaneous] transfers on an aggregate basis *may be necessary*."<sup>854</sup> Therefore, it is uncertain when the arm's length compensation may be determined for transfers of a going concern on an aggregate basis.

Furthermore, when the arm's length valuation needs to be done on an aggregate basis, the guidelines have not regulated valuation techniques and the application thereof in a sufficient manner. The OECD Transfer Pricing Guidelines refer in general to valuation techniques that independent parties would apply in comparable circumstances, i.e. in acquisition deals. Also, the potential use of the unspecified methods used in the valuation of intangibles is considered in this connection.<sup>855</sup> Although this approach allows the use of income based methods, in particular the discounted cash flow method and its variations, which have been considered appropriate also from the perspective of the arm's length principle, the application of such methods in the transfer pricing context remains ambiguous. In addition, by referring to the valuation techniques used in the valuation of intangibles, the same aforementioned concerns become topical in transfers of a going concern. Hence, in the current situation, the OECD's guidance is too vague and does not provide concrete tools for determining arm's length compensations for transfers of a going concern in a predictable and reliable manner. The lacking guidance in this respect is contrary to the aims of the arm's length principle.

On the basis of the above mentioned, the OECD Transfer Pricing Guidelines cannot, in their present form, be used efficiently in the determination of arm's length compensations for transfers of something of value occurring in the

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<sup>854</sup> OECD Transfer Pricing Guidelines, 9.69.

<sup>855</sup> Ibid.

business restructuring context. This also means that the guidelines cannot currently be used as the guiding international transfer pricing standard that should be adopted consistently to domestic transfer pricing legislation and regulations, when the arm's length compensations are determined for such transfers. The aforesaid concerns need to be addressed and solved *de lege ferenda* by introducing necessary amendments and/or updates to the current guidance of the OECD Transfer Pricing Guidelines; this also enables complying with the arm's length principle more efficiently.



# 5 ELIMINATION OF UNCERTAINTIES

## RELATING TO TRANSFER PRICING

### 5.1 GENERAL REMARKS

Several uncertainty factors relate to the transfer pricing of business restructurings. For example, it is not entirely clear to what extent transfers of intangible assets fall within the scope of application of national transfer pricing regulations. On the other hand, the determination of arm's length compensations for certain transfers of something of value, such as, intangibles or a going concern, may be difficult due to their unique characteristics and the lack of comparable uncontrolled transactions. If the tax authorities consider that the arm's length principle has not been followed in a related party transaction conducted in the course of a business restructuring, the transfer price used in the transaction will be adjusted. In such cases, an amount, which would have accrued had the related parties used such terms and conditions that independent parties would have used under similar conditions, shall be added to the taxable income of a related party.<sup>856</sup>

In addition to transfer pricing adjustments, specific penalties may be imposed on such tax underpayments. Pursuant to the Tax Code, if controlled parties have applied prices contrary to the arm's length principle, a penalty of 40 % of underpaid taxes shall be imposed on a taxpayer.<sup>857</sup> According to the Finnish transfer pricing provisions, in case a taxpayer has submitted deliberately or negligently tax returns, which contain essentially wrong information, a penalty of up to 30 % of the increase of the taxable income may be imposed.<sup>858</sup> Similarly, the IRS may impose a penalty of up to 40 % of the underpayment of tax, when a transfer price is deemed not to be arm's length.<sup>859</sup> In addition, a failure to comply with the regulated transfer pricing documentation requirements may similarly result in additional penalties under Russian and

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<sup>856</sup> See Article 105.3 of the Tax Code, § 31 of the AAP, Section 482 of the IRC and Treas. Reg. § 1.482-1(a).

<sup>857</sup> Article 129.3 of the Tax Code. A lower penalty of 20 % of the amount of underpaid taxes is applied for the financial years 2014–2016. It is unclear whether the penalty requires negligence; see Kaftannikov 2011, p. 47. If the taxpayer submits to the FTS transfer pricing documentation in the manner required by the Tax Code, it may be exempt from such penalty, see Article 129.3 of the Tax Code.

<sup>858</sup> § 32 of the AAP.

<sup>859</sup> See Section 6662(e) and 6662(h) of the IRC and Treas. Reg. § 1.6662-6. The penalties may be either transactional penalties or net adjustment penalties. On the other hand, reasonable cause and good faith as well as sufficient documentation may protect the taxpayer from the penalties based on the underpayment of taxes, see Treas. Reg. § 1.6662-6(b)(3) and § 1.6662-6(d).

Finnish law, while U.S. law does not regulate a specific penalty for the failure to maintain a transfer pricing documentation.<sup>860</sup>

Therefore, when the arm's length principle has not been followed in business restructuring transactions, it may result in surprisingly severe financial consequences for the parties. It should also be noted that the taxpayer has in practice the burden of proof under U.S. law,<sup>861</sup> meaning that the taxpayer must ultimately show that its transfer prices are arm's length in order to avoid penalties. While the burden of proof rests in Finland and Russian primarily with the tax authorities,<sup>862</sup> taxpayers should nevertheless seek to minimize the possibilities of authorities to challenge the pricing of related party transactions. By acting diligently companies may improve their positions in possible future disputes with tax authorities or even manage to avoid them. Consequently, a few examples of means that could be used to eliminate such uncertainties related to transfer pricing in business restructurings and ultimately to prevent potential tax authority interventions are discussed in the following.

## 5.2 ADVANCE PRICING AGREEMENTS

In an advance pricing agreement (APA) process, i.e. the APA process, a taxpayer negotiates and agrees with tax authorities in advance on transfer pricing questions in relation to a particular related party transaction. In an APA, it may be agreed, for instance, which transfer pricing method should be applied to the related party transaction and what type of documentation is required from the taxpayer in order to fulfill with the requirements of the arm's length principle.<sup>863</sup> Since the APA process makes possible that the tax authorities' prior approval of binding authority may be received on certain occasions, the process may be used to eliminate uncertainties arising out of certain transfer pricing questions in business restructurings.

In Russia, the conclusion of APAs with the tax authorities was not possible until the adoption of the newest transfer pricing provisions. Nowadays, the Tax Code's provisions concerning the conclusion of APAs can be regarded progressive due to their particularity. According to the provisions, only the

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<sup>860</sup> Article 129.4 of the Tax Code; § 32 of the AAP. In Finland, only the so-called large taxpayers are obliged by the transfer pricing documentation requirements; see § 14 a of the AAP. In the USA, the well-maintained transfer pricing documentation, however, protects the taxpayer against possible transfer pricing penalties imposed by the IRS, see Treas. Reg. § 1.6662-6(d).

<sup>861</sup> See e.g. Levey – Wrappe – Chung 2006, pp. 5–6.

<sup>862</sup> Article 105.3 of the Tax Code; Mäkelä 2014, pp. 299–300.

<sup>863</sup> Kukkonen – Walden 2010, p. 223.

largest taxpayers may conclude APAs, meaning that small and medium-sized enterprises may not apply for an APA at all.<sup>864</sup> A taxpayer willing to conclude an APA must prepare independently an APA application and ancillary documents related thereto, after which it must submit them to the tax authority, which in this case is the FTS. The FTS must give a decision about the application within six months, although the authorities have the right to extend the evaluation period up to nine months. Once the application is approved and an APA is granted, the tax authorities undertake to comply with the provisions of the APA as regards the determination of an arm's length compensation and the choice of transfer pricing method(s) in the related party transaction(s) in question. Both parties must comply with the provisions of the APA, even if the transfer pricing legislation would change after the conclusion of the APA.<sup>865</sup> Taxpayers must pay a relatively high state duty of RUB 2 million, when they apply for an APA. It should be noted that the state duty is not returned even when the FTS decides not to conclude an APA with the taxpayer.<sup>866</sup>

It is noteworthy to observe that pursuant to a letter issued by the FTS, in the conclusion of APAs, the principles of the OECD Transfer Pricing Guidelines are followed.<sup>867</sup> Similar to the guidelines, the Tax Code allows different type of APAs: *Unilateral APAs* are agreements concluded only between the taxpayer in question and the FTS. *Bilateral or multilateral APAs*, on the other hand, involve also the participation of tax authorities of other state(s), when the controlled transaction has cross-border implications. The bilateral or multilateral APAs can only be concluded with the states with which Russia has

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<sup>864</sup> A company can be regarded as a large taxpayer on a regional level, if, inter alia, its total annual revenue is between RUB 2 billion and RUB 20 billion and certain other requirements are met. The threshold for considering companies as large taxpayers on a federal level is even higher, see more in the following Minfin's and FTS's letters and resolutions: Prikaz FNS Rossii ot 26.10.2016 N MMV-7-2/582@ "O vnesenii izmenenij v prikaz FNS Rossii ot 16.05.2007 N MM-3-06/308@", Prikaz Ministerstva finansov Rossijskoj Federatsii ot 11 iyulya 2005 g. N 85n "Ob utverzhdenii Osobennostej postanovki na uchet krupnejshikh nalogoplatel'shhikov", Prikaz Federal'noj nalogovoj sluzhby ot 24 aprelya 2012 g. N MMV-7-2/274@ "O vnesenii izmenenij v prikaz FNS Rossii ot 16.05.2007 N MM-3-06/308@" and Prikaz Federal'noj nalogovoj sluzhby ot 16 maya 2007 g. N MM-3-06/308@ "O vnesenii izmenenij v prikaz MNS Rossii ot 16.04.2004 N SAEH-3-30/290@" (s izmeneniyami i dopolneniyami). The FTS publishes frequently news on its website at <http://www.nalog.ru> in relation to concluding APAs, and it has disclosed, for instance, that it has concluded APAs with such major Russian companies as Rosneft, Gazprom, Lukoil and Aeroflot.

<sup>865</sup> Articles 105.19–105.25 of the Tax Code.

<sup>866</sup> Article 333.33 of the Tax Code; Olofinskaya 2014, p. 72.

<sup>867</sup> Pis'mo Federal'noj nalogovoj sluzhby Rossii ot 12.01.2012 N OA-4-13/85@ "O zaklyuchenii soglashenij o tsenoobrazovanii dlya tselej nalogooblozheniya."

existing double taxation treaties.<sup>868</sup> Especially the use of bilateral/multilateral APAs is recommended in cross-border business restructurings in order to avoid double taxation.<sup>869</sup> Nonetheless, although the Tax Code regulates such a possibility, the Minfin has not yet published guidance in relation to concluding such agreements with foreign tax authorities. As the Tax Code's provisions particularly require that taxpayers must follow the procedure regulated by the Minfin in this respect,<sup>870</sup> due to the fact that such guidance does not yet exist, it seems that bilateral or multilateral APAs cannot currently be concluded at all under Russian law.<sup>871</sup>

Regardless of the unclarity with regard to bilateral/multilateral APAs, unilateral APAs may nevertheless bring positive results in terms of predictability of tax treatment,<sup>872</sup> especially if business restructurings lack transnational characteristics. Once the contract has been signed, the restructured company may avoid uncertainty associated with, for example, the arm's length pricing of intangibles. The FTS has the right to revoke or cancel the APA only if the taxpayer fails to comply with its provisions; otherwise, it is obliged to follow it.<sup>873</sup> In addition, APAs in general reduce costs and time of both taxpayers and the tax authorities by preventing potential litigations and time-consuming transfer pricing examinations.<sup>874</sup>

On the other hand, there are also many disadvantages relating to APAs, which may limit its usefulness in eliminating uncertainties especially in business restructurings in Russia. First, as discussed, only the so-called large taxpayers may conclude APAs in Russia, and thus small and medium-sized enterprises may not even apply for an APA. As business restructurings may be topical, for instance, for medium-sized multinational enterprises as well, this approach is troublesome. Second, the process relating to concluding APAs is very likely slow as the authorities have the right to consider the issue up to nine months — and in practice even more, as a taxpayer and the FTS must usually have

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<sup>868</sup> Article 105.20 of the Tax Code.

<sup>869</sup> In general, the OECD Transfer Pricing Guidelines also prefer the use of bilateral or multilateral APAs to reduce the risk of double taxation; see e.g. OECD Transfer Pricing Guidelines, 4.134 and 4.140–4.141.

<sup>870</sup> Article 105.20 of the Tax Code.

<sup>871</sup> However, the Minfin has started the process to prepare the required guidance for concluding bilateral/multilateral APAs already in 2015; see e.g. the Minfin's news from 21 August 2015 at [https://www.nalog.ru/rn77/taxation/transfer\\_pricing/5689967/](https://www.nalog.ru/rn77/taxation/transfer_pricing/5689967/). The Minfin published a discussion draft of the order on the procedure allowing the conclusion of multilateral APAs on 17 March 2017. Yet, the project has not still been completed.

<sup>872</sup> See about enhancing the predictability in general in Kaftannikov 2011, p. 48 and Olofinskaya 2014, pp. 72–73.

<sup>873</sup> Article 105.24 of the Tax Code.

<sup>874</sup> See e.g. OECD Transfer Pricing Guidelines, 4.155.

some necessary preliminary discussions before the taxpayer may submit an application.<sup>875</sup> Third, the state duty of RUB 2 million can be considered costly, especially as it will not be returned even in cases where an APA application is not approved. Therefore, the APAs may not necessarily save time or reduce costs under the current regulations. Fourth, as the Tax Code's provisions regarding APAs are fairly new, a predictable practice has not yet been established.

Finally, and most importantly, the unclarity with regard to the possibility of concluding bilateral or multilateral APAs at the moment may in its entirety restrict the use of APAs as an efficient remedy to address uncertainties associated with *cross-border business restructurings* in particular. If purely a unilateral APA is concluded, tax authorities of other jurisdictions may disagree with it and consider it to be contrary to the arm's length principle. In that case, taxpayers may not, for instance, achieve the increased level of certainty as to the tax treatment of business restructuring transactions they are aiming for, and, at worst, it may lead to double taxation, if the foreign tax administration refuses to follow its terms. In general, the bilateral or multilateral APAs are preferred over unilateral APAs for these reasons.<sup>876</sup>

Contrary to the Russian legislation, the Finnish tax legislation does not deal with the APA process specifically, nor can there be found any national formal guidance with respect to concluding APAs. Although specific regulations are missing in this regard, Finnish law contains an instrument similar to a unilateral APA, which could be used to eliminate uncertainties arising out of certain transfer pricing questions in business restructurings. The Finnish Central Tax Board and tax offices, including the Finnish Large Taxpayers' Office, may give preliminary rulings on various taxation issues, such as income taxation.<sup>877</sup> As the Finnish Central Tax Board may not give rulings on valuation matters, taxpayers may apply for preliminary rulings, which concern issues related to transfer pricing, primarily from tax offices and the Finnish Large Taxpayers' Office.<sup>878</sup> As discussed earlier, the Finnish Large Taxpayers' Office has previously expressly dealt with the transfer pricing aspects of business restructurings.<sup>879</sup>

As was the case with unilateral APAs, by applying for a preliminary ruling, a taxpayer may receive in advance a ruling on the tax treatment of issues relating

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<sup>875</sup> Kaftannikov 2011, p. 48.

<sup>876</sup> See e.g. OECD Transfer Pricing Guidelines, 4.156.

<sup>877</sup> See Chapter 8 of the AAP.

<sup>878</sup> This view has been expressed, *inter alia*, in the preliminary works; see HE 46/1996 vp, p. 14. See also e.g. Karjalainen – Raunio 2007, p. 220.

<sup>879</sup> Laaksonen 2006, pp. 428–437.

to income taxation, such as the transfer pricing of a related party transaction. Thus, it may in a similar manner receive information, for instance, on the transfer pricing methods applicable to such related party transactions. When a taxpayer applies for a ruling, it must identify in the application the main question for which the ruling is applied for and disclose all relevant facts related to the question. The ruling, which has gained legal force, is binding on the Finnish Tax Administration, if the taxpayer demands the Tax Administration to follow the ruling.<sup>880</sup> Thus, preliminary rulings have the same strengths as the unilateral APAs may, at least on certain occasions, have: predictability of the tax treatment of intragroup transactions and the time-saving factor. Unlike the APA process in Russia, the possibility of applying for a preliminary ruling is not limited only to large taxpayers in Finland, and the application fee can be considered low.<sup>881</sup>

On the other hand, it has been viewed in the legal literature that the decision-making of tax authorities in relation to preliminary rulings does not contain a similar dialogue between a taxpayer and tax authorities, which the APA process may have at its best; thus, the result may not be as advantageous as it could be for the taxpayer had there been discussions and negotiations with tax authorities during the process.<sup>882</sup> In addition, as preliminary rulings correspond to a large extent to unilateral APAs, they may have the same disadvantages as the latter may have. Therefore, especially the risk of double taxation is present also in preliminary rulings: as cross-border characteristics, such as co-operation between national tax authorities of different jurisdictions, are missing from preliminary rulings, there are no guarantees that foreign tax authorities would recognize and follow the terms and conditions of a preliminary ruling.

Unlike Russian law, the conclusion of bilateral/multilateral APAs is in some cases possible under Finnish law, provided that Finland has concluded a tax treaty with the foreign state(s) in question and the treaty contains a provision corresponding to Article 25 of the OECD Model Tax Convention, which regulates a mutual agreement procedure.<sup>883</sup> Although the national sources of law remain silent with regard to bilateral/multilateral APA processes (and APAs in general), two international sources applicable in Finland provide

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<sup>880</sup> § 85 of the AAP.

<sup>881</sup> The maximum application fee for the preliminary rulings in tax offices is EUR 2,290 (in 2017); see more about the costs at [https://www.vero.fi/fi-FI/Syventavat\\_veroohjeet/Asiakkaan\\_oikeudet\\_ja\\_velvollisuudet/Verohallinnon\\_maksulliset\\_palvelut/Hinnasto\\_Verohallinnon\\_maksullisista\\_pal](https://www.vero.fi/fi-FI/Syventavat_veroohjeet/Asiakkaan_oikeudet_ja_velvollisuudet/Verohallinnon_maksulliset_palvelut/Hinnasto_Verohallinnon_maksullisista_pal).

<sup>882</sup> Karjalainen – Raunio 2007, p. 220; Jaakkola et al. 2012, pp. 344–345.

<sup>883</sup> Finnish Tax Administration: APAs; Jaakkola et al. 2012, p. 340; Laaksonen 2013, p. 209. See Article 25 of the OECD Model Tax Convention for more precise provisions on mutual agreement procedure.

interpretive help in this: (i) the OECD Transfer Pricing Guidelines; and (ii) the communication of the Commission to the Council, the European Parliament and the European Economic and Social Committee on the work of the EU Joint Transfer Pricing Forum in the field of dispute avoidance and resolution procedures and on Guidelines for Advance Pricing Agreements within the EU<sup>884</sup>. Annex II to Chapter IV of the OECD Transfer Pricing Guidelines (*Guidelines for conducting Advance Pricing Arrangements under the Mutual Agreement Procedure (MAP APAs)*) contains guidance specifically applicable to bilateral/multilateral APA processes. The latter, on the other hand, contains EU Joint Transfer Pricing Forum's guidelines for APAs in the EU (hereinafter the "EU JTPF APA Guidelines"), which cover all kinds of APA processes in a detailed way. Although the sources are not binding on the EU member states, they provide useful and advisable guidance, which can be followed in bilateral/multilateral APA processes also in Finland in the above-mentioned manner.<sup>885</sup>

For instance, pursuant to the EU JTPF APA Guidelines, the APA process should have four stages: (a) Pre-filing stage/informal application; (b) Formal application; (c) Evaluation and negotiation of the APA; and (d) Formal agreement.<sup>886</sup> The OECD Transfer Pricing Guidelines' aforementioned Annex II contains similar guidance,<sup>887</sup> and thus both sources highlight the importance of co-operation and negotiations between tax authorities and the taxpayer during the process. The preference of the use of bilateral/multilateral APAs over unilateral APAs is also present, as the former can be used as an effective tool to tackle the double taxation,<sup>888</sup> because the bilateral/multilateral APAs should be binding on all tax authorities involved — also the Finnish Tax Administration.<sup>889</sup>

It seems that bilateral/multilateral APAs may provide effective results in terms of eliminating uncertainties relating to transfer pricing of cross-border

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<sup>884</sup> COM (2007) 71.

<sup>885</sup> The EU JTPF APA Guidelines "constitute a worthwhile blueprint for APA processes across the EU", see paragraph 37 of the communication of the Commission COM (2007) 71. The Finnish Tax Administration has expressly referred to these sources in its public statement, see Finnish Tax Administration: APAs.

<sup>886</sup> EU JTPF APA Guidelines, 20. See more about the different stages in paragraphs 20–47 of the EU JTPF APA Guidelines.

<sup>887</sup> See OECD Transfer Pricing Guidelines, Annex II to Chapter IV, 28–67.

<sup>888</sup> EU JTPF APA Guidelines, 6; paragraph 17 of the communication of the Commission COM (2007) 71; OECD Transfer Pricing Guidelines, Annex II to Chapter IV, 5 and 11; OECD Transfer Pricing Guidelines, 4.156 and 4.173.

<sup>889</sup> EU JTPF APA Guidelines, Appendix E; OECD Transfer Pricing Guidelines, Annex II to Chapter IV, 67–68; Finnish Tax Administration: APAs.

business restructuring under Finnish law. This requires that the group companies involved in the business restructuring are located in jurisdictions with which Finland has a double tax treaty according to which it is possible to engage in a mutual agreement procedure. In comparison with the above-discussed preliminary rulings, bilateral or multilateral APAs entitle (and require) taxpayers to be more active in the APA process and to negotiate on the terms and conditions of the APA, which in turn may produce more positive results for both parties and especially for taxpayers. More importantly, the risk of double taxation is also lower when compared to preliminary rulings. Regardless of possible disadvantages the multilateral or bilateral APAs may also have — for instance, the APA examination may require extensive documentation, which also contains sensitive information about the business<sup>890</sup> and the negotiation process with tax authorities of different jurisdictions may be lengthy and not always result in an agreement<sup>891</sup> — the benefits are usually greater (i.e. the elimination of possible uncertainties relating to a business restructuring). In this respect, the current legal situation in Finland deviates remarkably from the legal situation in Russia, where the conclusion of bilateral or multilateral APAs is not currently possible, and thus the potential uncertainties arising out of cross-border business transactions may not be eliminated effectively by using APAs.

The USA has a long history of APA processes, as the conclusion of APAs was made possible already in 1991.<sup>892</sup> The APA process is nowadays regulated under Revenue Procedure 2015-41 (Rev. Proc. 2015-41), which contains detailed guidance on each steps of the APA process as well as on the administration of the executed APAs.<sup>893</sup> The process conforms to a large extent to the APA processes in Russia and Finland: The APA process starts with informal discussions with the authority (pre-filing conference), after which an official APA request must be filed. If the APA request is accepted, the tax authorities will request from the taxpayer meetings and additional material before the finalization and signing of the APA.<sup>894</sup> Contrary to Russian and Finnish law, all kinds of APAs are accepted under U.S. law, i.e. unilateral, bilateral and multilateral APAs. Nonetheless, as was the case with the current situation in Finland, also the Revenue Procedure prefers clearly bilateral and multilateral APAs over unilateral APAs, and the latter may be applied for only

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<sup>890</sup> OECD Transfer Pricing Guidelines, 4.165–4.168.

<sup>891</sup> Finnish Tax Administration: APAs; OECD Transfer Pricing Guidelines, 4.169.

<sup>892</sup> Madrian – Weise 2014, p. 813; Markham 2005, p. 236.

<sup>893</sup> Furthermore, Rev. Proc. 2015-40, which deals with the procedures for requesting competent authority assistance under tax treaties, is useful in situations where the APA process involves tax authorities of other countries; see Section 5 of the Rev. Proc. 2015-41.

<sup>894</sup> See Sections 3–5 of the Rev. Proc. 2015-41.



on justified grounds.<sup>895</sup> An executed APA is binding upon the taxpayer and the IRS, meaning that the IRS will not contest the application of the covered method(s) to the covered issue(s) of the APA, if the taxpayer complies with the terms and conditions of the APA.<sup>896</sup>

Benefits of concluding APAs, such as the certainty of the tax treatment, co-operation factor as well as the time and cost savings, have also been recognized in the U.S. legal literature.<sup>897</sup> In the business restructuring context, in particular the bilateral or multilateral APAs could be thus helpful in the elimination of uncertainties, such as the transfer pricing treatment of transfers of certain intangibles or a going concern. This naturally requires that (bilateral) tax treaties, to which the USA is a signatory, make the use of such APAs possible. By the conclusion of bilateral or multilateral APAs, a multinational enterprise would be able to plan its transfer pricing strategy related to the business restructuring with more certainty and efficiency, as the IRS and foreign tax authorities would be bound by the terms and conditions of the APA (e.g. the applicable transfer pricing method). A unilateral APA does not bring the same benefits, most importantly, the increased level of certainty with regard to the tax treatment of business restructuring transactions; tax authorities of other countries may disagree with its terms and conditions, which may ultimately lead to double taxation.

As discussed above, the disadvantages of using APAs in general — such as the potentially lengthy APA process and the disclosure of confidential material<sup>898</sup> — may make the use of bilateral or multilateral APAs less attractive also in the USA, but in business restructurings the benefits are usually greater than such disadvantages (i.e. the elimination of possible uncertainties relating to the valuation of unique intangibles transferred in the business restructuring). Nevertheless, it is still noteworthy to mention that the APA request fees can be considered remarkably high in the USA: the user fee for a totally new APA request is USD 60,000 and the fee for the so-called ‘small case APAs’ is USD 30,000.<sup>899</sup> Consequently, the use of APAs in business restructurings of low commercial value may not likely be reasonable.

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<sup>895</sup> Sections 1.04 and 2.02 of the Rev. Proc. 2015-41. Such grounds may be, for instance, that an APA process is not possible with a foreign state pursuant to a tax treaty.

<sup>896</sup> Section 6.01–6.02 of the Rev. Proc. 2015-41.

<sup>897</sup> Levey – Wrappe – Chung 2006, pp. 106–108; Madrian – Weise 2014, p. 822; Markham 2005, pp. 246–262.

<sup>898</sup> See about disadvantages in the U.S. legal literature e.g. in Madrian – Weise 2014, p. 822; Markham 2005, pp. 262–283.

<sup>899</sup> Section 3.03–3.04 of the Appendix of Rev. Proc. 2015-41. One of the requirements for the small case APA treatment is that the controlled group has sales revenues of less than USD 500 million “in each of

All in all, the current legal situation in Finland and the USA enables the conclusion of unilateral or bilateral/multilateral APAs, which may be used as an effective tool to eliminate uncertainties related to the transfer pricing issues arising out of business restructurings, depending on the circumstances of the restructuring. As the unilateral APAs are not binding on foreign tax authorities in a similar manner and the Minfin has not yet published guidance with regard to concluding bilateral/multilateral APAs, APAs may not currently be used efficiently in cross-border business restructurings in Russia.

### **5.3 COMPLIANCE WITH DOCUMENTATION AND REPORTING REQUIREMENTS**

The importance of transfer pricing documentation cannot be underestimated. By documenting related party transactions in a comprehensive and thorough way, a taxpayer may demonstrate that the transfer prices used in controlled transactions and other transfer pricing issues related thereto (e.g. the choice of the transfer pricing methods) are in line with the arm's length principle, and thus the taxpayer may increase the chances of avoiding disputes and conflicts with tax authorities. Therefore, the fulfilment of transfer pricing documentation requirements may help companies to eliminate possible uncertainties related to transfer pricing issues also in business restructurings. Moreover, the relevance of documenting the transfer pricing decisions in particular in the business restructuring context has also been acknowledged by the OECD.<sup>900</sup> In the following, the documentation and reporting requirements of the Russian, Finnish and U.S. transfer pricing rules are discussed in more detail.

In general, national legislation usually regulates the requirements as regards transfer pricing documentation. Before examining the national provisions in this respect, the OECD's newest guidance in relation to transfer pricing documentation requirements should be reviewed, as the national sources are keen to follow the guidelines to a large extent. The OECD's BEPS Project introduced in 2015 several updates to Chapter V of the OECD Transfer Pricing Guidelines, which replaced the earlier guidance on the transfer pricing documentation for the purposes of enhancing the transparency of tax administration.<sup>901</sup> One of the most important amendments was the so-called *three-tiered approach* to transfer pricing documentation. The three-tiered

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its most recent three back years"; see in more detail in Section 3.04 of the Appendix of Rev. Proc. 2015-41.

<sup>900</sup> OECD Transfer Pricing Guidelines, 9.32–9.33.

<sup>901</sup> See OECD: BEPS Action 13, p. 9.

structure of transfer pricing documentation consists of “(i) a master file containing standardised information relevant for all MNE group members; (ii) a local file referring specifically to material transactions of the local taxpayer; and (iii) a Country-by-Country Report containing certain information relating to the global allocation of the MNE’s income and taxes paid together with certain indicators of the location of economic activity within the MNE group.”<sup>902</sup>

A master file should contain the following information about the multinational enterprise: an organizational structure, a description of the multinational enterprise’s businesses, a description of intangibles, a description of financial activities as well as a description of financial and tax positions.<sup>903</sup> On the other hand, the following information, among other things, should be included in a local file: a description of the management structure of the local entity, a local organization chart, a description of the business and business strategy pursued by the local entity, a description of the material controlled transactions, the amount of intra-group payments and receipts for each category of controlled transactions involving the local entity, a detailed comparability and functional analysis of the taxpayer and relevant associated enterprises with respect to each documented category of controlled transactions, an indication of the most appropriate transfer pricing method and a copy of existing unilateral and bilateral/multilateral APAs and other tax rulings to which the local tax jurisdiction is not a party.<sup>904</sup> It should especially be observed that the master file should include information on important business restructuring transactions occurred during the financial year, and the local file should contain a detailed description on whether the local company has been involved in or affected by business restructurings (and the aspects of such transactions should be explained).<sup>905</sup> The OECD suggests that the local file be should be finalized “no later than the due date for the filing of the tax return for the fiscal year in question.” The master file should be finalized by the due date of the tax return for the parent company of the group.<sup>906</sup>

The Country-by-Country Report provides information on a multinational enterprise’s allocation of income, taxes and business activities on a tax jurisdiction-by-tax jurisdiction basis. The report should contain, inter alia, tax jurisdiction specific information about revenues, profit or loss before taxes, income tax paid and accrued in the current year, stated capital, accumulated

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<sup>902</sup> OECD Transfer Pricing Guidelines, 5.16.

<sup>903</sup> OECD Transfer Pricing Guidelines, 5.18–5.21 and Annex I to Chapter V.

<sup>904</sup> OECD Transfer Pricing Guidelines, 5.22–5.23 and Annex II to Chapter V.

<sup>905</sup> OECD Transfer Pricing Guidelines, Annex I and II to Chapter V. See also OECD Transfer Pricing Guidelines, 9.32

<sup>906</sup> OECD Transfer Pricing Guidelines, 5.30–5.31.

earnings, number of employees, tangibles assets other than cash or cash equivalents and main business activities.<sup>907</sup> It must be noted that the Country-by-Country Report obligation applies only to multinational groups of companies with consolidated group revenue of at least EUR 750 million in the immediately preceding fiscal year.<sup>908</sup> As a main rule, tax jurisdictions should require the Country-by-Country Reports from an ultimate parent entity of the group<sup>909</sup>, which is resident in their country, after which this information should be exchanged on an automatic basis with other tax jurisdictions, in which the group operates.<sup>910</sup>

In Russia, the current transfer pricing provisions of the Tax Code also deal with the transfer pricing documentation and reporting requirements. According to the Tax Code, a taxpayer must maintain a documentation with which the taxpayer may justify the pricing applied in its controlled transactions.<sup>911</sup> The documentation should include information, inter alia, about the activities of parties that participate in controlled transaction(s); a list of related parties with which controlled transactions are entered into; a description of the controlled transactions (including, inter alia, the terms and conditions of the transactions and the method applied in the determination of prices); a functional analysis; the reasons for the application of certain transfer pricing methods; the sources of information; and a description of the calculation of the arm's length range. Taxpayers should also provide any other information, which has affected the pricing of the related party transactions. The documentation has to be finalized by the end of May of the following year at the latest, as the FTS has the right to request the taxpayers to present the transfer pricing documentation as of June 1 of the calendar year, which follows the year in which the related party transaction was conducted. The documentation must be presented within 30 working days of the FTS's request.<sup>912</sup>

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<sup>907</sup> OECD Transfer Pricing Guidelines, Annex III to Chapter V.

<sup>908</sup> OECD Transfer Pricing Guidelines, 5.53.

<sup>909</sup> An ultimate parent company is basically the entity that is required to prepare consolidated financial statements pursuant to the accounting principles and law; the concept is defined more precisely in Article 1.6 of the OECD's model legislation related to Country-by-Country Reporting, see Annex IV to Chapter V of the OECD Transfer Pricing Guidelines (Country-by-Country Reporting Implementation Package).

<sup>910</sup> OECD Transfer Pricing Guidelines, 5.58 and 5.60.

<sup>911</sup> Article 105.15 of the Tax Code.

<sup>912</sup> Ibid. The FTS has also published more specific guidance on preparing and filing transfer pricing documents for tax control purposes, which should be followed by taxpayers; see the FTS's letter Pis'mo Federal'noj nalogovoj sluzhby Rossii ot 30.08.2012 N OA-4-13/14433@ "O podgotovke i predstavlenii dokumentatsii v tselyakh nalogovogo kontrolya." See also the Minfin's letter according to which local tax

In addition to the general transfer pricing documentation requirements, the Tax Code also regulates a specific reporting requirement, pursuant to which taxpayers are required to report to the FTS all the related party transactions occurred in the calendar year. The notification must contain information, *inter alia*, about each controlled transaction (the amount of income derived and expenses incurred), the subject of the transaction, the parties to the transaction as well as the relevant terms and conditions. The notification must be submitted by 20 May of the calendar year, which follows the year in which the related party transaction was conducted.<sup>913</sup> The notification can be deemed to be closely associated with the general transfer pricing documentation requirement. As the tax authorities will automatically receive information about commercially important transactions through the mandatory reporting process, on the basis of the notifications they can decide what transactions should be examined in a more precise manner in the form of tax audits and of which controlled transactions they should therefore demand the taxpayer to present transfer pricing documentation.

The current Russian legislation deviates in terms of content from the newest documentation and reporting principles set out in the OECD Transfer Pricing Guidelines, as the existing law in principle requires only a local file — which also is not completely consistent with the OECD's concept — to be maintained. However, it should be noted that the Russian transfer pricing documentation and reporting requirements are likely to be revised soon to be to a great extent comparable with the provisions of the OECD Transfer Pricing Guidelines. The Minfin published on 6 September 2016 a new legislative project, according to which the aforementioned three-tiered approach to transfer pricing documentation and reporting would also be adopted to the Tax Code.<sup>914</sup> Pursuant to the proposed draft legislation, the members of the large multinational groups of companies would be obliged to maintain a transfer pricing documentation consisting of a master file, a local file and a Country-by-Country Report. Although Russia is not a member state of the OECD, the proposed provisions correspond in terms of the content to the above-discussed documentation requirements of the OECD Transfer Pricing Guidelines. A master and local file should be presented to the tax authorities, if required by them, within three months of the date of such request, and no earlier than 15 months from the date on which the financial year ended. Country-by-Country

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offices are also entitled to demand transfer pricing documentation from taxpayers, when conducting tax audits, Pis'mo Ministerstva finansov Rossijskoj Federatsii ot 24.02.12 N 03-01-18/1-13.

<sup>913</sup> Article 105.16 of the Tax Code.

<sup>914</sup> Project 02/04/10-15/00041254 (O vnesenii izmenenij v chast' pervuyu Nalogovogo kodeksa Rossijskoj Federatsii (v svyazi s realizatsiej mezhdunarodnogo avtomaticheskogo obmena informatsiej o finansovykh schetakh i dokumentatsiej po mezhdunarodnym gruppam kompanij)).

Reports, on the other hand, should be provided automatically either by the parent company, if resident in Russia, or secondarily by a Russian company, which is a member of the group of companies, within 12 months from the date on which the financial year ended.<sup>915</sup>

However, a few differences can also be found between the proposed legislation and the OECD Transfer Pricing Guidelines. The three-tier documentation and reporting requirements would apply only to taxpayers in Russia, if they belong to a multinational group of companies with the total revenue of at least RUB 50 billion (pursuant to the consolidated financial statements for the previous financial year).<sup>916</sup> In addition, it seems that the prevailing documentation and reporting requirements discussed above and the proposed provisions would coexist after enacting the latter. As the existing documentation requirements (which could be described as local file requirements) differ in terms of content from the proposed local file requirements at least in some respects (the latter concentrate more on cross-border transactions), this would basically mean that Russia would *de facto* adopt a four-tier approach to transfer pricing documentation and reporting. The proposed legislation was originally planned to be applied to financial years starting from 1 January 2017, but the legislative project is still pending.<sup>917</sup>

The Finnish transfer pricing documentation requirements are regulated in § 14 a – § 14 e of the AAP. Finnish law has a specific threshold for the liability to prepare and maintain transfer pricing documentation. Small and medium-sized enterprises are not required to prepare transfer pricing documentation: such enterprises are taxpayers, which employ less than 250 people; which have a turnover of EUR 50 million or less, or total balance sheet is EUR 43 million or less; and the criteria of small and medium-sized enterprises as enumerated in the Commission Recommendation 2003/361/EC<sup>918</sup> are applicable to the enterprise. According to the general transfer pricing documentation and reporting requirements, a taxpayer that meets the aforementioned conditions is liable for preparing a report, in which all related party transactions (with the meaning of § 31 of the AAP) conducted during the calendar year have been disclosed. However, it must be noted that the transfer pricing documentation requirement is limited only to controlled transactions conducted between a

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<sup>915</sup> Proposed Articles 105.16-1–105.16-6 of the Tax Code.

<sup>916</sup> Proposed Article 105.16-3 of the Tax Code.

<sup>917</sup> The status of the project was reviewed last time on 10 July 2017. See the project details at <http://regulation.gov.ru/projects#npa=41254>.

<sup>918</sup> EU Commission Recommendation of 6 May 2003 concerning the definition of micro, small and medium-sized enterprises 2003/361/EC.

Finnish company and a foreign group company or between a foreign entity and a permanent establishment located in Finland.<sup>919</sup>

The more detailed provisions dealing with the content of the transfer pricing documentation were recently amended to implement the OECD's BEPS Project (or more specifically, Action 13 of the BEPS project) and the recently-revised Council Directive 2011/16/EU of 15 February 2011 on administrative cooperation in the field of taxation, which deals with the country-by-country reporting within the EU.<sup>920</sup> As a result, the Finnish transfer pricing documentation and reporting requirements are now in line with the newest documentation principles of the OECD Transfer Pricing Guidelines. Pursuant to the new documentation requirements, the transfer pricing documentation must contain information about the group of companies and the taxpayer, corresponding in terms of the content to a master file and a local file under the OECD Transfer Pricing Guidelines.<sup>921</sup> However, the taxpayer is not required to provide information about the group (i.e. a master file), if the aggregate amount of controlled transactions conducted between the taxpayer and each related party does not exceed EUR 500,000 during the tax year.<sup>922</sup> The transfer pricing documentation — a master file and a local file — should be submitted to the Finnish tax authorities within 60 days from their request. Nonetheless, a taxpayer is never required to submit the documentation earlier than six months after the end of the financial year.<sup>923</sup>

Furthermore, the new provisions also introduce the Country-by-Country reporting requirement, which conforms in terms of content to the OECD's principles. Similar to the OECD Transfer Pricing Guidelines, the Country-by-Country reporting obligation is applied only to multinational group of companies with the consolidated group revenue of at least EUR 750 million in the immediately preceding financial year. Furthermore, primarily the ultimate parent company of the group resident in Finland, and secondarily — under certain circumstances — another group company resident in Finland, is obliged to submit the report to the Finnish Tax Administration. The report

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<sup>919</sup> § 14 a of the AAP.

<sup>920</sup> The Council Directive 2016/881/EU of 25 May 2016 amended Directive 2011/16/EU as regards mandatory automatic exchange of information in the field of taxation.

<sup>921</sup> § 14 b of the AAP. The consistency has also been confirmed in the preliminary works, see HE 142/2016 vp, pp. 3, 7–8.

<sup>922</sup> § 14 b of the AAP. In addition, a taxpayer is exempt of providing certain information usually included in a local file, if the aggregate amount of controlled transactions conducted between the taxpayer and a related party does not exceed EUR 500,000 during the tax year; see § 14 b of the AAP for more information.

<sup>923</sup> § 14 c of the AAP.

must be submitted within 12 months after the end of the financial year in question.<sup>924</sup>

In conclusion, Finnish law corresponds on a large scale to the OECD Transfer Pricing Guidelines and the proposed Tax Code's regulations in terms of transfer pricing documentation and reporting requirements. However, as seen above, there exist also certain deviations: The discussed thresholds are applied to the documentation requirement, which results in that not all taxpayers are required to maintain a documentation or include certain information in their documentation. In addition, the Finnish legislation does not obligate every taxpayer to report annually on controlled transactions in a similar manner as the Russian legislation does.

The U.S. transfer pricing documentation requirements are regulated in the Treasury Regulations. Pursuant to the regulations, in order to avoid a transfer pricing penalty, a taxpayer must maintain "sufficient documentation to establish that the taxpayer reasonably concluded that, given the available data and the applicable pricing methods, the method (and its application of that method) provided the most reliable measure of an arm's length result under the principles of the best method rule." The documentation must be 'contemporaneous', as it must be prepared in connection with the annual income tax return, the deadline for the preparation being the date on which the tax return must be submitted at the latest.<sup>925</sup> Similar, sufficient documentation must also be maintained to justify the use of unspecified method(s).<sup>926</sup> The transfer pricing documentation must be submitted to the IRS within 30 days of the IRS's request.<sup>927</sup>

The transfer pricing documentation should comprise the so-called principal documents and background documents. The principal documents should describe the basic transfer pricing analysis conducted by the taxpayer and consist of, inter alia, the following information: an overview of the taxpayer's business; a description of the taxpayer's organizational structure; any documentation explicitly required by the regulations under Section 482 of the IRC; a description of the method selected and an explanation of why that method was selected; a description of the alternative methods that were considered and an explanation of why they were not selected; a description of the controlled transactions and any internal data used to analyze those transactions; a description of the comparables that were used, how comparability was evaluated, and what adjustments were made; an

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<sup>924</sup> § 14 d of the AAP. Also, an authorized group company may be liable for submitting the report.

<sup>925</sup> Treas. Reg. § 1.6662-6(d)(2).

<sup>926</sup> Treas. Reg. § 1.6662-6(d)(3).

<sup>927</sup> Treas. Reg. § 1.6662-6(d)(2)(iii)(A) and § 1.6662-6(d)(3)(iii)(A).



explanation of the economic analysis and projections relied upon in developing the method; and a general index of the principal and background documents and a description of the recordkeeping system used for cataloging and accessing those documents.<sup>928</sup>

The background documents, on the other hand, are documents, which will support all the possible “assumptions, conclusions, and positions contained in principal documents.”<sup>929</sup> These kinds of documents may be, for example, sales journals, cash receipts, profit and loss statements, pricing documents and transfer pricing filings prepared for foreign authorities.<sup>930</sup> The background documents are not required to be submitted to the IRS, when only the principal documents have been requested; when a specific request for background documents is made, they must also be provided in the above-mentioned manner within 30 days of such a request.<sup>931</sup>

In addition to the actual transfer pricing documentation to be provided on the request of the IRS, a U.S. taxpayer must annually report controlled transactions conducted with foreign related parties (including information about the amount and the nature of such transactions) to the IRS. The information must be submitted by using specific forms.<sup>932</sup> Despite the fact that such information is not provided on the basis of the Treasury Regulations under Section 482, the information may play an important role, when the IRS considers when to request transfer pricing documentation from a taxpayer for audit purposes.<sup>933</sup>

Although the above-discussed U.S. transfer pricing provisions are not based on the newest documentation and reporting principles of the OECD Transfer Pricing Guidelines, the documentation requirements are to a large extent in line with the OECD Transfer Pricing Guidelines and thus as well with the Finnish transfer pricing documentation requirements and the proposed Russian provisions.<sup>934</sup> Similar to Russian law, the U.S. rules also require annual reporting on controlled transactions; however, the reporting requirement concerns only controlled transaction with foreign related parties, while the Russian rules require that all related party transactions are reported to the tax authorities.

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<sup>928</sup> Treas. Reg. § 1.6662-6(d)(2)(iii)(B) and § 1.6662-6(d)(3)(iii)(B).

<sup>929</sup> Treas. Reg. § 1.6662-6(d)(2)(iii)(C) and § 1.6662-6(d)(3)(iii)(C).

<sup>930</sup> Treas. Reg. § 1.6662-6(d)(2)(iii)(C) and § 1.6038A-3(c); Hill 2011, p. 639.

<sup>931</sup> Treas. Reg. § 1.6662-6(d)(2)(iii)(C).

<sup>932</sup> Treas. Reg. § 1.6038-2(a) and § 1.6038-2(a). These forms are Form 5471 and Form 5472.

<sup>933</sup> Stuffer – Hiller 2009, p. 10.

<sup>934</sup> It has also been viewed in the legal literature that, for instance, the master file requirements of the OECD are comparable with the U.S. requirements, see Levey – Gerdes – Mansfield 2016, p. 404.

On the other hand, the OECD Transfer Pricing Guidelines have nevertheless had a direct impact on the U.S. transfer pricing documentation and reporting requirements in one respect. On 29 June 2016, the IRS issued new Treasury Regulations<sup>935</sup>, which introduced the annual Country-by-Country reporting requirement. Pursuant to the regulations, an ultimate parent company of a U.S. multinational enterprise group must prepare an annual Country-by-Country Report, provided that the annual revenue of the group for the immediately preceding financial year was at least USD 850,000,000 (which equals to EUR 750,000,000).<sup>936</sup> The Country-by-Country report should contain, inter alia, tax jurisdiction specific information about revenues, profit or loss before income tax, income tax paid and accrued in the current year, stated capital, accumulated earnings, number of employees and net book value of tangible assets other than cash or cash equivalents.<sup>937</sup> From this perspective, the regulations are comparable with the OECD Transfer Pricing Guidelines' corresponding provisions.<sup>938</sup> The regulations apply to taxable years that begin on or after 30 June 2016.<sup>939</sup> The report must be provided in connection with the ultimate parent company's annual income tax return, following the deadlines for filing the return.<sup>940</sup>

Notwithstanding that there might be slight differences between the current documentation and reporting requirements of Russia, Finland and the USA, they aim to serve the same purpose: the examination and verification of whether the pricing and/or other terms and conditions of related party transactions comply with the arm's length principle. For instance, the OECD has stated that the transfer pricing documentation has three objectives: to ensure that taxpayers consider the transfer pricing requirements appropriately in establishing prices and other terms and conditions of controlled transactions; to provide tax authorities with necessary information for the transfer pricing risk assessment purposes; and to provide the tax authorities also with useful information, which could be used in conducting transfer pricing audits.<sup>941</sup>

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<sup>935</sup> Treas. Reg. § 1.6038-4.

<sup>936</sup> Treas. Reg. § 1.6038-4(a) and § 1.6038-4(h); 81 Fed. Reg. 42487.

<sup>937</sup> Treas. Reg. § 1.6038-4(d).

<sup>938</sup> See also Levey – Gerdes – Mansfield 2016, pp. 404–405. The purpose of the Treasury Regulations has also been to adopt as extensive reporting burden as described in the OECD BEPS Action 13; see 81 Fed. Reg. 42482, 42485, 42486.

<sup>939</sup> Treas. Reg. § 1.6038-4(k).

<sup>940</sup> Treas. Reg. § 1.6038-4(f).

<sup>941</sup> OECD BEPS Action 13, pp. 12–14.

Taking into account the above said, a thorough transfer pricing documentation may serve as a useful tool to prevent potential transfer pricing disputes with tax authorities also in business restructurings. When a taxpayer has documented the decision-making and its positions with regard to the choices made in the business restructuring transactions — for instance, the determination of arm's length compensations for certain asset transfers, including the choice of the most appropriate transfer pricing method(s) and the decisions made in the comparability analysis — it may demonstrate that that it has followed the arm's length principle, or at least it has diligently and in good faith tried to follow it. This could lead to that the tax authorities would be less anxious to interfere in the business restructuring transactions as they would had the taxpayer neglected to maintain transfer pricing documentation. For instance, the Finnish Tax Administration has expressly underlined the importance of transfer pricing documentation in business restructurings.<sup>942</sup> On the other hand, maintaining a comprehensive and detailed transfer pricing documentation is not an easy task and may require a lot of resources and time,<sup>943</sup> and therefore achieving more certainty of the tax treatment has its own price. However, documentation requirements as well and costs and burdens related thereto should not nevertheless be disproportionate to the circumstances of the case.<sup>944</sup>

## 5.4 SELF-INITIATED ADJUSTMENTS

After concluding a related party transaction, it may be possible that a taxpayer finds out that the transaction results in prices or margins, which actually fall outside the arm's length range. In such situations, a taxpayer may be willing to adjust its income tax base so that it would reflect the income, which would have been earned had the correct pricing applied in the transaction initially.<sup>945</sup> These kinds of self-initiated transfer pricing adjustments can thus be used as a remedy to avoid possible transfer pricing disputes with tax authorities arising from non-compliance with the arm's length principle.<sup>946</sup> While in some countries the national legislation may specifically regulate the possibility of such adjustments, in other countries the issue have not been addressed at all.

Pursuant to the Russian Tax Code, a taxpayer may make self-initiated adjustments to its tax base in order to comply with the arm's length principle,

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<sup>942</sup> See Finnish Tax Administration: Transfer Pricing in Business Restructurings.

<sup>943</sup> Markham 2005, pp. 162, 170.

<sup>944</sup> OECD Transfer Pricing Guidelines, 5.28.

<sup>945</sup> Snyder 2005, p. 20; Karjalainen – Raunio 2007, pp. 238–239.

<sup>946</sup> The self-initiated adjustment is in some sources known as compensatory adjustment, see e.g. OECD Transfer Pricing Guidelines, 4.38–4.39; Lucas Mas 2009, pp. 209–210.

if the prices originally applied in a related party transaction do not conform to arm's length prices.<sup>947</sup> The amendments can be done at the end of the calendar year, and the details of such self-initiated amendments must be disclosed in the income tax return concerning the financial year.<sup>948</sup> It is important to note that the Russian provisions do not allow downward adjustments, but only upward tax base adjustments, i.e. adjustments that result in an increase of the taxable income.<sup>949</sup>

The Finnish legislation lacks particular provisions on self-initiated transfer pricing adjustments. The preliminary works of the AAP have addressed the questions indirectly. According to the preliminary works, a taxpayer should follow its transfer prices already during the tax year, as it is not possible in Finland to amend taxable income downward on a tax return.<sup>950</sup> This approach suggests that the self-initiated transfer pricing amendments can be done at least during the tax year, if a taxpayer has noticed before the end of the tax year that the pricing applied in a certain related party transaction has not been in line with the market price. This possibility has been recognized also in the legal literature where it has been stated that the pricing could be in that case corrected already in the accounts for the accounting period.<sup>951</sup>

Nevertheless, it has also been viewed in the legal literature that, in addition to the amendments made during the tax year, self-initiated amendments could be made after the completion of the financial statements on a tax return, after submitting the income tax return but before the end of the tax-assessment season, and even after the end date of the tax-assessment season (i.e. 31 October of each year) by applying specifically for a tax amendment/correction. These kinds of adjustments make possible also downward adjustments of tax bases.<sup>952</sup> This position is based on § 55 of the AAP and the tax practice related thereto, according to which a correction can be made for the benefit of a taxpayer on its request within five years of the beginning of the year following

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<sup>947</sup> Article 105.3 of the Tax Code.

<sup>948</sup> Article 105.3 of the Tax Code. The FTS has also published letters, in which it deals with self-initiated adjustments in more detail, see Pis'mo FNS Rossii ot 11.03.2015 N ED-4-13/3833@ "Ob osushchestvlenii nalogoplatel'shnikami samostoyatel'nykh korrektyrovok v sootvetstvii s punktom 6 stat'i 105.3 NK RF", Pis'mo FNS Rossii ot 21.04.2014 N GD-4-3/7582@ "O poryadke otrazheniya v nalogovoj deklaratsii samostoyatel'noj korrektyrovki nalogovoj bazy po nalogu na pribyl' organizatsii" and Pis'mo FNS Rossii ot 14.03.2013 N ED-4-3/4303@ "O primenenii polozhenij punkta 6 stat'i 105.3 Nalogovogo kodeksa Rossijskoj Federatsii v chasti samostoyatel'noj korrektyrovki nalogovoj bazy po NDPI i summy ehlogo naloga."

<sup>949</sup> Article 105.3 of the Tax Code.

<sup>950</sup> HE 107/2006 vp, p. 19.

<sup>951</sup> Karjalainen – Raunio 2007, pp. 238–239, 243.

<sup>952</sup> Karjalainen – Raunio 2007, pp. 243–244; Jaakkola et al. 2012, pp. 386–387.

the tax assessment year, regardless of the tax consequences of such a correction. However, if tax authorities have already requested from a taxpayer a clarification or other information with regard to transfer pricing of a certain controlled transaction, the taxpayer may not anymore — after such a request — amend the pricing of the transaction (or demand a correction) in order to comply with the arm's length principle.<sup>953</sup> Notwithstanding this, rather obvious, limitation, by applying this interpretation in business restructurings, a multinational company could have a remarkably broader right to make self-initiated transfer pricing amendments in comparison with the Russian provisions, provided that also other tax provisions (such as, the provisions prohibiting tax evasion) have been complied with.

In the USA, Section 482 of the IRC regulates the IRS's right to make transfer pricing adjustments (to distribute, apportion or allocate income in order to prevent evasion of taxes etc.), but does not expressly authorize a taxpayer to similar actions.<sup>954</sup> However, the Treasury Regulations have discussed the so-called *taxpayer's use of Section 482* of the IRC, which deals with the issue to a certain extent. Pursuant to the regulations, "if necessary to reflect an arm's length result, a controlled taxpayer may report on a timely filed U.S. income tax return (including extensions) the results of its controlled transactions based upon prices different from those actually charged."<sup>955</sup> This sentence can be interpreted to allow a taxpayer to make necessary transfer pricing adjustments, if the original pricing of a controlled transaction has not been in line with the arm's length standard.

However, after a tax return has been filed within the reporting period, the adjustment right is limited only to upward adjustments resulting in the increase of taxable income. According to the Treasury Regulations, a taxpayer may not apply the provision of Section 482 "at will"; this means that "no untimely or amended returns will be permitted to decrease taxable income based on allocations or other adjustments with respect to controlled transactions."<sup>956</sup> Despite the criticism, the validity of the regulation has also been upheld in the decision of the U.S. Court of Federal Claims.<sup>957</sup>

The U.S. provisions thus restrict the taxpayer's right to make voluntarily both downward and upward transfer pricing adjustments to situations where the income tax return has not been filed yet, provided that the adjustments are

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<sup>953</sup> Jaakkola et al. 2012, pp. 386–387.

<sup>954</sup> See also Treas. Reg. § 1.482-1(a)(2).

<sup>955</sup> Treas. Reg. § 1.482-1(a)(3).

<sup>956</sup> Ibid.

<sup>957</sup> See *Intersport Fashions West Inc. v. U.S.*, 109 A.F.T.R. 2d 2012-927 (Fed. Cl. 2012). See about the criticism in Herrington – Lowell 2013, pp. 253–257 and Ryan – Kotarba 2012, pp. 1–3.

necessary in order to comply with the arm's length standard and the new results of the related party transactions will be reported in the income tax return. Nevertheless, as the Russian tax provisions do not allow downward adjustments in any case, and all adjustments must be reported in the annual income tax return at the latest, U.S. taxpayers have a broader right to make transfer pricing adjustments in this sense. On the other hand, the Finnish approach to taxpayers' self-initiated transfer pricing adjustments may go even further, if the above-discussed broader interpretation is applied.

In any case, taxpayers' self-initiated transfer pricing adjustments may lead to that potential transfer pricing disputes with tax authorities are avoided, for example, in situations where a taxpayer notices the failure of applying arm's length prices in its controlled transactions before filing the annual income tax return. For instance, a taxpayer may receive information on comparable transactions or other similar information affecting the pricing of a related party transaction that was not available at the time of the transaction and, in light of the newest information, it appears that the original pricing of the transaction is not arm's length. Nevertheless, in comparison with APA processes and/or maintaining a comprehensive transfer pricing documentation, self-initiated transfer pricing adjustments cannot be used as effectively to eliminate uncertainties arising from transfer pricing issues in business restructurings. As voluntary adjustments can be used only as post-transaction tools, they are not particularly helpful when a multinational company examines, *inter alia*, to what extent a business restructuring should fall within national transfer pricing regulations and what (transfer pricing) methods should be used in determining the arm's length prices for transfers of certain assets in business restructuring transactions.

## **5.5 ECONOMIC RATIONALE AND COMPLIANCE WITH ANTI-AVOIDANCE RULES**

As discussed, by restructuring its business models a group may achieve considerable tax savings. Therefore, a question of whether a multinational enterprise may amend its business models mainly — or solely — for tax saving purposes is also important. The conditions for amending business models are not usually regulated directly by national legislation, and hence the issue may be to some extent unclear. However, it has been generally viewed that a group must primarily have commercial or business-related reasons for business restructurings.<sup>958</sup> If business restructuring transactions lack economic rationale, tax authorities could be willing to intervene in such transactions and

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<sup>958</sup> See e.g. Engblom et al. 2010, p. 547.

even ignore the forms of the transactions.<sup>959</sup> Thus, this section deals with general anti-abuse and anti-avoidance rules, which could also be applied in the business restructuring context and which therefore should be ultimately followed by related parties. While the compliance with such rules does not help to eliminate uncertainties in relation to, *inter alia*, determination of arm's length compensations for certain asset transfers conducted in the restructuring or the choice of the transfer pricing methods, it reduces the risk of that the national tax authorities would be willing to challenge the transfer pricing terms and conditions of the controlled transactions performed in the course of the business restructuring — or even the whole restructuring — as discussed briefly in Section 3.7.<sup>960</sup>

According to the OECD's guidance, the fact that the reason behind business restructuring is to obtain tax advantages and tax benefits does not constitute a breach of the arm's length principle as such. It may be economically reasonable for related parties to restructure business models for the sake of achieving tax benefits. In addition, tax authorities cannot decide on behalf of multinational companies where their business activities may take place.<sup>961</sup> Thus, according to the OECD, the tax authorities may not challenge the transactions performed in the context of business restructurings solely on the basis of that a company receives tax benefits as a result of business restructuring or that tax considerations have been a crucial factor when the restructuring decision was made.

Nevertheless, pursuant to the provisions of the OECD Transfer Pricing Guidelines, tax authorities may have the right to interfere in related party transactions in business restructurings in certain exceptional cases. Chapter IX of the OECD Transfer Pricing Guidelines states that tax authorities may not disregard part or all of the business restructuring or replace it with alternative transactions, unless the exceptional circumstances regulated in paragraph 1.122 are met.<sup>962</sup> According to paragraph 1.122 of the OECD Transfer Pricing Guidelines,

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<sup>959</sup> Kroppen – Silva 2011, pp. 27–28.

<sup>960</sup> It should be noted that the arm's length principle, which has been discussed in more detail in the previous sections, can also be regarded as an anti-avoidance provision; the difference between the provisions and doctrines to be dealt with in this section and the arm's length principle is that the former rules may give tax authorities the right to disregard and recharacterize *whole transactions*, while the latter usually authorizes the authorities to challenge *the terms and conditions* of transactions (as is the case, e.g. in Finland).

<sup>961</sup> See OECD Transfer Pricing Guidelines, 9.34 and 9.38; Article 9 of the OECD Model Tax Convention.

<sup>962</sup> OECD Transfer Pricing Guidelines, 9.35.

“the transaction as accurately delineated *may be disregarded*, and if appropriate, *replaced by an alternative transaction*, where the arrangements made in relation to the transaction, viewed in their totality, *differ from those which would have been adopted by independent enterprises behaving in a commercially rational manner in comparable circumstances*, thereby preventing determination of a price that would be acceptable to both of the parties *taking into account their respective perspectives and the options realistically available to each of them* at the time of entering into the transaction.”

Thus, the most important question in examining the applicability of such non-recognition provision is whether the business restructuring transaction(s) in question has the commercial rationality, which would exist in transactions between unrelated parties under similar conditions. If such commercial rationality is missing, i.e. unrelated parties would not enter into such arrangements under comparable economic circumstances, tax administration may disregard the related party transactions conducted in the course of a business restructuring.<sup>963</sup> When the commercial rationality of the business restructuring is examined, it is in general more appropriate to review the rationality of all controlled transactions as a whole. Only in cases, where related party transactions are not economically interrelated, such transactions should be analyzed separately. Furthermore, the restructuring must make commercial sense to all participating related parties, taking into consideration, inter alia, other realistically available options.<sup>964</sup>

When taking into account that there are no specific regulations concerning business restructurings in the Finnish legislation, these OECD’s provisions should be considered, when examining whether Finnish law sets any restrictions or requirements for amending multinational companies’ business models. On the other hand, the Finnish tax legislation also contains general anti-avoidance provisions, which could be applied to business restructurings. Therefore, in addition to the OECD’s aforementioned guidance, the general anti-abuse and anti-avoidance rules followed in Finland set the requirements for, inter alia, whether business restructurings may be executed solely for the purpose of achieving tax benefits.

§ 28 of the AAP regulates unlawful avoidance of taxes and is the most important anti-avoidance rule in Finland,<sup>965</sup> and its applicability to transfer

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<sup>963</sup> OECD Transfer Pricing Guidelines, 1.123–1.124, 9.35–9.38.

<sup>964</sup> OECD Transfer Pricing Guidelines, 9.36–9.37. See also OECD Transfer Pricing Guidelines, 9.27–9.31.

<sup>965</sup> The main provision regulating transfer pricing, § 31 of the AAP, can also be considered an anti-avoidance rule, as it gives the tax authorities right to interfere in related party transactions, which



pricing questions has been lately discussed quite widely in Finnish courts and legal literature. Pursuant to § 28.1 of the AAP, if the legal form of condition or action does not conform to the actual nature or intention of the matter, the taxation of the matter must be executed in a way as if the real form would have been used in the case. In addition, if the purchase price, other consideration or performance time in a purchase or other agreement or other action has been taken obviously for the purpose of avoiding payable taxes, taxable income and assets may be assessed. According to § 28.2 of the AAP, if it is obvious that the taxation should be executed in accordance with § 28.1, the taxpayer should be given the opportunity to clarify the matter. If the taxpayer does not give explanation of that the legal form of condition or action corresponds to the actual nature or intention of the matter or that the action has not been taken obviously for the purpose of avoiding payable taxes, the taxation shall be executed in accordance with the said rules.

In the business restructuring context, § 28 of the AAP means that if the tax authorities question the legal form of the transactions performed in the course of business restructurings (or the whole restructuring) by showing evidences of that there are obvious reasons for challenging the transaction, the taxpayer must present clarifications which show that legal form conforms to the actual nature of the transactions or that the *obvious reason* behind the transactions was not the avoidance of payable taxes. The requirement of obviousness means in practice that the taxpayer must show in the latter scenario that there has been at least *partly* other acceptable justifications for the transaction than tax-related reasons.<sup>966</sup> This could be done by showing commercial justifications for performing such transactions or any other non-tax related justifications, which could be partly behind the restructurings.

The decision practice of the Finnish Large Taxpayers' Office shows that the companies have usually justified their business restructurings with arguments relating to commercial or business rationale.<sup>967</sup> In addition, in the legal literature it has been stated that § 28 of the AAP may be applied to business restructurings, if they clearly lack commercial rationale and the main purpose for executing the business restructuring is the avoidance of payable taxes.<sup>968</sup> However, such a conclusion cannot be made that in the absence of commercial reasons or justifications business restructurings will always fall within the scope of § 28 of the AAP. As discussed above, the provision does not as such require that business restructurings should be justified only by commercial

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conditions are not in line with the arm's length principle. See also § 52h of the Act on the Taxation of Business Profits and Income from Professional Activities.

<sup>966</sup> Rynänen 2001, p. 276. See also footnote 156 on the same page.

<sup>967</sup> Laaksonen 2006, p. 429.

<sup>968</sup> Juusela – Tuominen 2011, p. 315; Laaksonen 2006, p. 429.

reasons; taxpayers also can provide any other explanations, which show that the obvious purpose of the transaction was not the tax avoidance of payable taxes.<sup>969</sup> On the other hand, by demonstrating that there are business/commercial grounds for such transactions, it is usually the easiest way for the taxpayers to show that the legal form of the arrangement corresponds to the real intention of the matter and that the transactions have not been performed solely for the purpose of avoiding payable taxes, but there have been also other acceptable justifications for the transaction.

Regardless of the nature of the grounds (commercial or other acceptable grounds) presented by taxpayers, the business restructuring may hence result in that the taxpayers achieve tax benefits. In other words, taxpayers have the right to seek tax benefits allowed by law, which are not contrary to the legislator's intention, provided that the aforementioned requirements of § 28 of the AAP are also met.<sup>970</sup> Therefore, if the business restructuring is obviously targeted at avoiding payable taxes and/or the legal form of the actions does not correspond to the real content of the actions, it is more than likely that the tax authorities are willing to challenge the business restructuring pursuant to § 28 of the AAP. On the contrary, business restructurings may be executed for the purpose of receiving tax benefits, if the transaction is performed within the limits of § 28 of the AAP. The decision practice of the Finnish Large Taxpayers' Office also supports this view, as business restructurings have been accepted in its decisions even if restructurings have brought tax benefits for the companies involved.<sup>971</sup> Moreover, it should be observed that tax authorities have in practice only exceptionally challenged business restructurings on the basis of § 28 of the AAP.<sup>972</sup> This is not a surprise as the threshold for the application of § 28 of the AAP is high.<sup>973</sup>

The legal state in Finland seems to be largely, but not entirely, in line with the OECD's approach. The national provisions gives the tax authorities the right to examine, whether the legal form and the actual content of transactions in the course of business restructurings correspond to each other. The transactions may be disregarded and replaced, if the forms of transactions are not consistent with their real content. In addition, by showing economic rationale taxpayers can usually avoid speculations and suspicions of unlawful tax avoidance in business restructurings. However, Finnish law does not require specifically commercial rationality, unlike the OECD; taxpayers can also show other acceptable (non-tax related) reasons for the transaction,

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<sup>969</sup> Rynänen 2001, p. 276; Isomaa-Myllymäki 2014, p. 471.

<sup>970</sup> See also Knuutinen 2014a, p. 172.

<sup>971</sup> Laaksonen 2006, p. 429.

<sup>972</sup> Juusela – Tuominen 2011, p. 315.

<sup>973</sup> Rynänen 2001, p. 276.

which have at least partly affected the transaction. In addition, both sources recognize that taxation may be a factor that affects the business restructuring decision, and taxpayers may always try to achieve tax benefits that are permitted by law. Finally, under both sources of law, the form or characterization of a transaction may be disregarded only in exceptional cases.

Nevertheless, there can also be seen one larger difference between the approaches of Finnish law and the OECD's guidance. The authorization to non-recognize and disregard the form of related parties' actions and arrangements is regulated in Finnish law by a specific anti-avoidance provision, which is not a transfer pricing provision by nature (§ 28 vs. § 31 of the AAP), while the OECD's corresponding rules are located in its transfer pricing guidelines and the OECD Model Tax Convention. In practice, this means that the Finnish transfer pricing provision, § 31 of the AAP, cannot be interpreted in a way which would allow to disregard the entire legal form of a related party transaction; the provision only gives the tax authorities the right to make transfer pricing adjustments. Tax authorities must apply § 28 of the AAP, if they are willing to contest the form or characterization of a transaction. As the threshold for applying § 28 of the AAP is high, it can be applied to business restructurings only rarely. The tax authorities have tried to interpret § 31 in a way, which would allow them to challenge the legal forms of transactions by only applying § 31 of the AAP, but the courts have in their decisions overruled tax authorities' actions.<sup>974</sup>

Unlike many other countries, the Russian tax legislation does not contain a general anti-avoidance rule. Hence, the Russian legislation does not directly give the Russian tax authorities the right to disregard or non-recognize legal forms of transactions or actions for tax purposes. However, it should be noted that a concept of tax evasion<sup>975</sup> has been nevertheless regulated in the Russian

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<sup>974</sup> See decision KHO 2014:119 and Isomaa-Myllymäki 2014, pp. 469–483, which deals with the said case. The recharacterization of transactions under § 28 and 31 of the AAP has also been discussed in the legal literature quite extensively in recent years. For instance, Helminen has stated that the OECD Transfer Pricing Guidelines cannot be interpreted in a way, which would expand the right to recharacterize transactions contrary to what is permitted by national provisions of law, and therefore the recharacterization is possible only under § 28 of the AAP, see Helminen 2014a, p. 93. See also Lehtonen 2014, pp. 183–194 and Juusela 2014, pp. 55–62, where the same opinion has been expressed. Knuutinen has discussed the concepts of form and content in Finnish tax law, which may be useful in this situation; see Knuutinen 2006, pp. 789–808. It should be noted that this study does not deal in detail with the question of acceptable tax planning versus prohibited tax evasion. See more about this in, for example, Tikka 1972, pp. 26–33.

<sup>975</sup> In Russian *uklonenie ot uplaty nalogov*. The concept has also been discussed e.g. in the Russian Federation's outline for tax policy in 2013–2015 “Osnovnye napravleniya nalogovoj politiki Rossijskoj Federatsii na 2013 god i na planovyj period 2014 i 2015 godov”, p. 46.

Criminal Code. Articles 198 and 199 of the Russian Criminal Code regulate the tax evasion as unlawful tax avoidance conducted by means of non-submission of the tax notification or other documents required by the Russian tax legislation. The provisions do not include as such an authorization for tax authorities to challenge the terms and conditions of actions of taxpayers; they only deal with the tax avoidance in situations where a taxpayer has not submitted notifications and other documents required by tax law provisions.<sup>976</sup> As Articles 198 and 199 are also located in the Russian Criminal Code, they are purely criminal provisions,<sup>977</sup> whereas the Finnish provision (§ 28 of the AAP) is located in the Finnish tax legislation and lacks criminal content. Consequently, as the aforementioned Russian provisions are very restricted and are not in nature anti-avoidance rules, they are not comparable with the provisions of Finnish law and the OECD's guidance.

The question of whether controlled parties may execute a business restructuring in Russia solely for the purpose of achieving tax benefits or whether there are certain regulated restrictions for executing business restructurings in practice must be thus examined from other sources of law. Regardless of that the Tax Code is lacking in content in this regard, the Russian tax authorities have been eager to intervene in arrangements in which the form of the transaction does not correspond to the real economic substance. The authorities' actions may be first based on certain provisions of the Russian Civil Code. A transaction, which has been performed only for the purpose of that it would seem that a transaction has been executed, without any intention to create actual legal relation and liabilities, is void. In addition, a sham transaction, which is a transaction executed in order to hide another transaction, is void. In case of a sham transaction, the transaction in question must be deemed to be actually a transaction, which the parties in reality had in mind taking into account the substance of the transaction, and legal provisions must be applied to the transaction accordingly.<sup>978</sup>

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<sup>976</sup> Article 199, which concerns the tax evasion by legal persons, regulates that certain amount of unpaid taxes and neglect of duties with regard to tax notifications and documentation may trigger criminal liability. The underpayment of taxes, which exceeds RUB 2,000,000 over a period of three financial years, given that the unpaid sum is more than 10 % of total taxes due, already triggers criminal liability for companies. In addition, criminal liability arises always from the underpayment of taxes, which exceeds RUB 6,000,000. More about the application of Articles 198 and 199 in Lopashenko 2006, pp. 617–630.

<sup>977</sup> Article 199 of the Russian Criminal Code has also been discussed in the legal literature usually from the criminal law perspective, see e.g. publication Aleksandrov, Igor': *Uklonenie ot uplaty nalogov. Osnovy kriminalisticheskoy kharakteristiki*. Litres 2015.

<sup>978</sup> Article 170 of the Civil Code.

In the legal literature, these provisions have been considered to provide the tax authorities with efficient means to intervene in taxpayers' aggressive tax planning.<sup>979</sup> However, they do not provide direct answers to the question whether business or economic rationale is at least to a certain extent required for executing business restructurings or whether restructuring can solely be performed for tax minimizing purposes. On the other hand, the FTS may on the basis of these provisions challenge the legal form of actions performed in the course of a business restructuring, if the controlled parties' real intention derives from the legal form. Thus, these provisions correspond to § 28 of the AAP at least partly.

More importantly, the FTS may justify their possible actions and interventions in business restructurings by referring to the decision of the plenary session of the Supreme Commercial Court of the Russian Federation No. 53, dated 12 October 2006<sup>980</sup>. In the decision, the Supreme Commercial Court introduced first time the *principle of unjustified tax benefit* (in Russian *neobosnovannaya nalogovaya vygoda*). According to the decision, the tax authorities may investigate taxpayers' transactions, if they are not in line with reasonable economic purposes, but rather bring unjustified tax benefit to taxpayers.

The Supreme Commercial Court's ruling was based on an assumption that a taxpayer always behaves in good faith. If the taxpayer receives *bona fide* tax benefits, the benefits are not unjustified. A tax benefit is understood as the decrease of taxpayer's tax liabilities and it may result, for instance, from the reduction of the tax base. The tax authorities may however override this presumption and consider the taxpayer's tax benefits unjustified, if they are able to show that the forms of the taxpayer's transactions do not correspond to their actual content or that the transactions do not serve any reasonable economic or business purposes indicated by the taxpayer.<sup>981</sup> It should be noted that, if a transaction's sole purpose is the achievement of tax benefits, it may never be regarded as a reasonable economic consideration that could validate the legality of the taxpayer's transaction.<sup>982</sup>

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<sup>979</sup> Evdokimov – Konnov 2011, p. 631.

<sup>980</sup> Postanovlenie Plenuma Vysshego Arbitrazhnogo suda Rossijskoj Federatsii ot 12 oktyabrya 2006 goda N 53 "Ob otsenke arbitrazhnymi sudami obosnovannosti polucheniya nalogoplatel'shnikom nalogovoj vygody."

<sup>981</sup> The court discussed examples of conditions, which may constitute an evidence of unjustified tax benefits. For instance, the impossibility to realistically execute the transactions in question (for example, due to the lack of resources of the company) may indicate that the achieved tax benefits are unjustified.

<sup>982</sup> Postanovlenie Plenuma Vysshego Arbitrazhnogo suda Rossijskoj Federatsii ot 12 oktyabrya 2006 goda N 53 "Ob otsenke arbitrazhnymi sudami obosnovannosti polucheniya nalogoplatel'shnikom nalogovoj vygody".

It has been criticized in the legal literature that the principle and the concepts introduced by the Supreme Commercial Court have not yet been codified into the Tax Code.<sup>983</sup> Nonetheless, the principle of unjustified tax benefits has been adopted by the courts in several cases and has thus become binding law in practice.<sup>984</sup> In consequence, by applying the principle of unjustified tax benefits, the Russian tax authorities have the right to intervene also in related party transactions, such as business restructurings, if the real substance of the alleged transaction deviates from the recorded form/characterization or if there are no reasonable economic justifications for the transaction and the taxpayer consequently receives unjustified tax benefits.

All in all, the provisions of the Russian Civil Code give the authorities the right to disregard transactions, forms of which do not correspond to their real content. This has also been confirmed in the aforementioned tax law related decision of the Russian Supreme Commercial Court. Moreover, the principle of unjustified tax benefits introduced in the said decision entitles the tax authorities to challenge also transactions, which lack reasonable economic/business rationale and at the same time bring taxpayers unjustified tax benefits. In this respect, Russian law sets even a bit more strict requirements for executing business restructurings than Finnish law: Under § 28 of the AAP, the taxpayer needs to show that the business restructuring transaction was executed partly for other reasons than taxation issues, and such reasons are not limited to only business justifications. Russian law, on the other hand, accepts in principle only business-related justifications. Nevertheless, Russian law does not deviate much from the Finnish provisions in this regard, especially when companies have in practice relied mainly on economic grounds also in Finland, when they have decided on business restructurings.

Does U.S. law authorize the tax authorities to interfere in related party transactions performed in the course of business restructurings and disregard

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<sup>983</sup> See e.g. Budylin 2008, p. 75. However, it should be observed that the principle of unjustified tax benefits is planned to be regulated in the Tax Code in the foreseeable future. Draft law No. 529775-6 was presented to the State Duma in 2015. According to the draft law, new Article 54.1 of the Tax Code would prohibit transactions, which aim at the underpayment of taxes, if the transactions have been performed only for the tax avoidance purposes. See more about the legislative project in the preliminary work *Zakonoproekt N 529775-6 "O vnesenii izmenenij v chasti pervuyu i vtoruyu Nalogovogo kodeksa Rossijskoj Federatsii ob ustanovlenii predelov osushhestvleniya prav i ispolneniya obyazannostej nalogoplatel'shikom)"*, pp. 1–3. The draft law is currently being discussed in the State Duma, and, if approved, it may come into force shortly after the act has been signed by the President of Russia.

<sup>984</sup> See e.g. *Opreделение Vysshego Arbitrazhnogo Suda RF ot 11 yanvarya 2009 g. N 16307/08* and *Postanovlenie FAS Vostochno-Sibirskogo okruga ot 12.12.2013 g. N A78-2777/2013*.

them similarly? First, there are several provisions in the US legislation, which could be characterized as anti-avoidance provisions. For example, the IRC has a provision, according to which the tax authorities may deny a deduction, credit or allowance, if a corporation acquires property and “the principal purpose for which such acquisition was made is evasion or avoidance of Federal income tax by securing the benefit” of such deduction, credit or allowance, which the corporation would not otherwise enjoy. In principle, such provision could also be applied to business restructurings.<sup>985</sup>

However, the main source of U.S. law with regard to anti-avoidance rules has been and still is the US case law and the judicial doctrines developed therein. Many important rules, which give the authorities the right to challenge transactions, have been introduced by the courts. *Gregory v. Helvering*<sup>986</sup>, the landmark case in U.S. tax law, introduced *the business purpose doctrine*. The business purpose doctrine can be summarized as follows: A taxpayer should usually have a business purpose or reason for performing a transaction. Such business purpose cannot be solely the avoidance of taxes or achieving tax benefits. This means that even though a taxpayer meets all the requirements of a certain tax provision, it may not always be entitled to tax benefits resulting from the said tax provision, if the transaction otherwise lacks business purpose. In that case, the tax authorities may disregard or recharacterize the transaction for tax purposes. The business purpose requirement may be explicitly stated in a provision of a tax statute. On the other hand, if the business purpose requirement has not been codified, the courts may invoke the business purpose requirement by applying the business purpose doctrine in conjunction with other anti-avoidance provisions or doctrines.<sup>987</sup>

As the business purpose requirement is not extensively legislated in tax law provisions or regulations, the business purpose doctrine is often applied in practice together with other anti-avoidance rules, one of them being *the economic substance doctrine*.<sup>988</sup> The economic substance doctrine has been extensively used by courts to disallow tax benefits achieved by taxpayers in transactions where the purpose of receiving tax benefits has been strongly present. According to the doctrine, courts or tax authorities have the right to deny tax benefits, which a taxpayer could receive in a transaction had the IRC's or other tax provisions literally been followed, if the transaction lacks the

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<sup>985</sup> Zollo 2011, p. 764. See also Treas. Reg. § 1.701-2(b).

<sup>986</sup> *Gregory v. Helvering*, 293 U.S. 465 (1935).

<sup>987</sup> *Ibid*; Varma – West 2010, p. 828; Tooma 2008, pp. 45–46.

<sup>988</sup> Faber 2010, p. 331. The courts have not always been able to make a clear distinction between the business purpose doctrine and the economic substance doctrine. The existence of business purpose has been often examined, when courts have investigated whether the transaction in question has economic substance.

economic substance and the result of the transaction is thus against the legislator's intention. In order to investigate the presence of the economic substance, the courts have traditionally examined, whether (i) the transaction in question has led to objectively reasonable changes in the taxpayer's economic position (other than which have resulted from the received tax benefits) and has thus objective economic substance; and whether (ii) the taxpayer has subjectively any other business purposes for the transaction than tax related. Some courts have demanded that the transaction in question must meet both requirements in order to avoid the courts'/authorities' interference in the transaction by relying on the economic substance doctrine; some courts have required that only either (i) or (ii) has to be present in the transaction. The former approach is called *the conjunctive test*<sup>989</sup> and the latter *the disjunctive test*<sup>990</sup>. Finally, some of the courts<sup>991</sup> have used both requirements, objective economic substance and taxpayer's subjective business purpose, as factors useful to consider, when examining a transaction's lawfulness.<sup>992</sup> The economic substance doctrine has been recently codified in Section 7701(o) of the IRC. According to the new provision,

“in the case of any transaction to which the economic substance doctrine is relevant, such transaction shall be treated as having economic substance only if—

- (A) the transaction changes in a meaningful way (apart from Federal income tax effects) the taxpayer's economic position, and
- (B) the taxpayer has a substantial purpose (apart from Federal income tax effects) for entering into such transaction.”<sup>993</sup>

The IRC has thus adopted the so-called conjunctive test, as “the term ‘economic substance doctrine’ means the common law doctrine under which tax benefits ---- with respect to a transaction are not allowable if the transaction does not have economic substance or lacks a business purpose.”<sup>994</sup> It has been viewed in the legal literature that the codification of the economic substance doctrine does not bring much change in the authorities' or courts' behavior and practices, and the authorities are after the codification at least as eager as before to apply the doctrine to transactions that particularly have

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<sup>989</sup> The conjunctive test has been applied by courts in e.g. *Pasternak v. Commissioner*, 990 F.2d 893 (6th Cir. 1993) and *United Parcel Service of America, Inc. v. Commissioner*, 254 F.3d 1014 (11th Cir. 2001).

<sup>990</sup> The disjunctive test has been applied by courts in e.g. *Rice's Toyota World, Inc. v. Commissioner*, 752 F.2d 89 (4th Cir. 1985) and *Horn v. Commissioner*, 968 F.2d 1229 (D.C. Cir. 1992).

<sup>991</sup> See e.g. *Keeler v. Commissioner*, 243 F.2d 1212 (10th Cir. 2001).

<sup>992</sup> See e.g. *Silverman – Lerner – Kidder* 2006, p. 426; *Zollo* 2011, p. 765; *Varma – West* 2010, p. 828.

<sup>993</sup> Section 7701(o)(1) of the IRC.

<sup>994</sup> Section 7701(o)(5)(A) of the IRC.



effect on a taxpayer's income taxation.<sup>995</sup> The economic substance doctrine is also present in the Treasury Regulations interpreting Section 482 of the IRC. The Treasury Regulations allow the IRS to disregard and recharacterize transactions, which do not conform to their economic substance.<sup>996</sup> Therefore, the economic substance doctrine must be taken into account specifically in transfer pricing questions and thus when planning the transfer pricing of a business restructuring.

In addition, there are some other judicial doctrines of U.S. tax law, which may be relevant, when reviewing the framework for conducting business restructurings. The so-called *substance-over-form doctrine*, which was first time applied in *Commissioner v. Court Holding Co.*,<sup>997</sup> allows the tax authorities to disregard transactions and deny tax benefits, if the forms of transactions have not been conformed to the actual content or substance of the matter.<sup>998</sup> The substance-over-form doctrine thus resembles the economic substance doctrine and the business purpose doctrine discussed above; the latter doctrines can actually be considered variations of the substance-over-form doctrine, and they are often applied together.<sup>999</sup> The *step transaction doctrine*, on the other hand, means that separate steps of an arrangement may be regarded as one transaction for taxation purposes, if a taxpayer achieves tax benefits that it would not have otherwise achieved and the arrangement was divided into separate steps merely to receive the tax benefits.<sup>1000</sup> In addition, the IRS may in general invoke the *sham transaction doctrine*, when it wants to intervene in taxpayers' transactions. The definition of the sham doctrine is ambiguous, but the main content is that courts may disregard transactions, if there has not in reality been a transaction, a transaction lacks economic substance, a transaction lacks business purpose or there has existed a variation of the said circumstances. The common characteristic is that a court or the IRS, by referring to these conditions, treats a transaction as a sham transaction and thus disregards the transaction for taxation purposes.<sup>1001</sup>

It should be noted that courts or tax authorities may invoke at the same time different aforementioned doctrines, and the doctrines may be overlapping

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<sup>995</sup> Glickman – Calhoun 2010, p. 659.

<sup>996</sup> Treas. Reg. § 1.482-1(d)(3)(ii)(B). See also the IRS's notice 2014-58 "Additional Guidance Under the Codified Economic Substance Doctrine and Related Penalties."

<sup>997</sup> *Commissioner v. Court Holding Co.*, 324 U.S. 331 (1945).

<sup>998</sup> Varma – West 2010, p. 829.

<sup>999</sup> Tooma 2008, pp. 48–49.

<sup>1000</sup> See Varma – West 2010, pp. 832–833, which also discusses three different tests that the authorities and courts have applied in examining whether a taxpayer's steps should be treated as one transaction.

<sup>1001</sup> Graber 2000, p. 362; Postlewaite 2005, p. 142.

with other doctrines in some situations.<sup>1002</sup> On the other hand, it is not relevant, whether the tax authorities apply a particular doctrine to a transaction over other similar doctrines or whether they use the term “sham transaction doctrine” instead of using the term “substance-over-form doctrine”. As discussed above, the doctrines have basically the same meaning and content: a taxpayer may not achieve (unjustified) tax benefits and the taxpayer’s transaction may be disregarded for tax purposes, if there have not been sound business purposes or reasons for the transaction, the transaction lacks economic substance or the form of the transaction otherwise has not conformed to the real content.

Overall, the IRS may rely on various anti-avoidance provisions and doctrines, both legislated and judicial, also in business restructurings, if it suspects that the transactions performed in the course of a business restructuring do not comply with the requirements of U.S. tax law in the discussed manner. It has also been viewed in the legal literature that the mentioned anti-avoidance doctrines can particularly be topical in business restructurings.<sup>1003</sup> It is therefore noteworthy to pay attention to the reasons, with which a business restructuring and especially the transfer pricing of the transactions performed in the course of the restructuring are justified, or otherwise there might be a risk of that the IRS is willing to disregard or recharacterize the whole restructuring or the transactions performed therein for tax purposes.

In this respect, U.S. tax law is largely in line with the approaches taken by Finnish and Russian law. As mentioned earlier, Russian law sets a bit more severe requirements for conducting business restructurings than Finnish law. Russian law basically requires reasonable economic justifications for conducting transactions in general and therefore also in the business restructuring context, while pursuant to Finnish law a taxpayer must justify transactions by referring generally to other reasons than taxation related. Notwithstanding that such reasons do not need to be business-related, usually taxpayers have relied on such in practice. As discussed, the anti-avoidance doctrines and provisions of U.S. law require similarly in many cases economic substance or business purpose, and ultimately transactions cannot be conducted purely for the purpose of avoiding taxes/achieving tax benefits contrary to the legislator’s intention, as was the case also in Russia and Finland. Furthermore, while some of the doctrines lack uniform definitions and have not been applied by the courts or authorities in a consistent way, it is clear that taxpayers may not use in business restructuring transactions legal forms, which do not conform to their real content, and therefore U.S. law conforms to a large degree to Russian and Finnish law also in this regard.

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<sup>1002</sup> Varma – West 2010, p. 827; Tooma 2008, p. 40.

<sup>1003</sup> Amerkhail – Granwell 2009, pp. 437–438; Varma – West 2010, pp. 764–765, 772.

As a conclusion, it can be stated that Russian, Finnish and U.S. law allow companies to organize their business models quite broadly in various ways even though the executed business restructuring would lead to some tax benefits and the taxable income in the jurisdiction would decrease. Tax authorities may not dictate, where taxpayers may locate their assets and activities. However, the national tax-avoidance provisions and doctrines set restrictions in terms of *how* such restructurings may be executed. The transactions performed in the business restructuring context must always conform to their real substance, and taxpayers may not implement business restructurings solely for the purpose of avoiding taxes or achieving tax benefits that would be contrary to the legislator's intent. Usually taxpayer must show business- or economic-related purposes, reasons and/or justifications for the business restructuring, or otherwise there might be a risk of that national tax authorities would be willing to disregard or recharacterize transactions conducted in the restructuring for tax purposes or even contest the purpose of the whole business restructuring. Hence, also other anti-avoidance rules than the arm's length principle must be complied with, when planning the transfer pricing of business restructurings, as this also may in turn reduce the probability of transfer pricing disputes with the tax authorities.<sup>1004</sup>

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<sup>1004</sup> It should be observed that this section did not discuss exhaustively the means of national tax authorities to disregard and recharacterize related party transactions in business restructurings. The purpose of this section was to purely demonstrate that, when taxpayers plan the transfer pricing of business restructuring and execute the business restructuring, also other potentially applicable tax law provisions must be followed.

## **6 CONCLUSION**

### **6.1 RUSSIAN, FINNISH AND U.S. TAX LAW APPROACHES TO BUSINESS RESTRUCTURINGS AND COMPLIANCE WITH THE ARM'S LENGTH PRINCIPLE**

A business restructuring is often associated with a new business strategy adopted by a group of companies. In such cases, it is important for the multinational enterprise in question to be able to predict the potential tax treatment and tax consequences of the business restructuring in order to ensure the rationality of the restructuring also from a tax law perspective. From the point of view of transfer pricing, this means that the tax law provisions, case law and other applicable sources of law should preferably provide taxpayers with appropriate information and means for such a decision-making.

Regardless of fundamental differences in the legal and judicial systems, the current transfer pricing rules of Russian, Finnish and U.S. tax law correspond to each other and to the OECD Transfer Pricing Guidelines' provisions to a great degree. Nonetheless, certain questions that are of great importance and relevance at present in transfer pricing — in particular, the transfer pricing of business restructurings — have not been yet addressed to a sufficient extent by national laws. Consequently, the importance of Chapter IX of the OECD Transfer Pricing Guidelines cannot be overemphasized especially in countries, where its guidance is followed in practice by tax authorities and courts.

As discussed, the Russian Tax Code's new rules are widely based on the OECD's Transfer Pricing Guidelines, although Russia is not an OECD member state and the FTS and Russian courts are not obliged to follow the guidelines. Therefore, while the OECD Transfer Pricing Guidelines may provide interpretive help in situations where the Tax Code's transfer pricing rules are ambiguous and difficult to apply in practice, there is no certainty of that the tax authorities would interpret the unclear provisions in accordance with the OECD Transfer Pricing Guidelines. Moreover, the guidelines cannot be used in the interpretation of the Tax Code's provisions in a way, which would lead to that the wording, content or scope of a provision would ultimately be broadened against the legislator's intent. Although the transfer pricing rules regulated in the Tax Code are quite widely consistent with the OECD's transfer pricing rules, they also have their own peculiarities, which result in that on certain occasions the transfer pricing treatment may differ from the Western

practice quite extensively. Business restructurings form a good example in this respect.

As a result of the narrow scope of application of the Russian transfer pricing rules and the lack of clarifying interpretations of legally binding nature in this respect, it seems that only transfers of tangible property and intellectual properties fall within the scope of the Russian transfer pricing rules in the business restructuring context. This leads to that transfers of other assets of commercial value as well as premature terminations or renegotiations of agreements likely fall outside the scope of the Russian transfer pricing rules. This approach is troublesome especially from the perspective of the arm's length principle and is contrary to the approach taken by the OECD Transfer Pricing Guidelines.

For instance, it is self-evident that also goodwill or other intangibles that are not legally protected by particular national regulations and/or recorded on a company's balance sheet may have commercial value, which could be compensated in transactions between independent parties. Intellectual properties are not the only intangibles that may have commercial value. However, as the Tax Code's transfer pricing regulations are not, in the aforesaid manner, applied to intangibles in general, they do not become objects of transfer pricing in business restructurings and ultimately do not have to be compensated at arm's length — which is also inconsistent with the arm's length principle.

Furthermore, no legal support can be found from the Tax Code and other sources of Russian tax law for the view that interrelated assets and functions transferred in the course of a business restructuring could be identified and valued on an aggregate basis, when a functioning business unit (i.e. going concern) is transferred. Therefore, all transfers of something of value occurred in a business restructuring should always be examined on an asset-by-asset basis.

The lack of legal support for treating a transfer of a functioning business unit on an aggregate basis causes problems in terms of the arm's length principle. It is likely that on certain occasions, for instance in business acquisitions, independent parties would analyze and remunerate simultaneous transfers of assets and functions as a whole. The traditional approach based on separate valuations of transferred items does not take into consideration all the peculiarities involved in transfers of a going concern, and therefore the end result may deviate largely from what independent parties would have ended up with in comparable circumstances. Thus, the arm's length principle is not efficiently complied with also in this respect.

In addition, although transfers of risks as well as premature renegotiations or terminations of agreements should be taken into account at least to some extent in the transfer pricing analysis of business restructurings, they may not currently be objects of transfer pricing in Russia at all. As the latter should be compensated at arm's length on a case-by-case basis in some situations, Russian law deviates from the arm's length standard also in this regard.

In consequence, the compliance with the arm's length principle, which should be the guiding principle also behind the Russian national transfer pricing provisions, is not realized effectively in business restructurings in Russia. As the above-discussed transaction types are not subject to transfer pricing, related parties and unrelated parties are not in the end treated equally for tax purposes in all circumstances. There thus exists an urgent need for amendments *de lege ferenda* to the existing transfer pricing rules in Russia in this respect. It would be important to revise/update the prevailing transfer pricing provisions and other applicable regulations in Russia to be in line with the aims of the arm's length principle, i.e. to include the possibility to consider transfers of intangibles and a going concern as well as premature terminations or renegotiations of existing agreement as objects of transfer pricing, if they would be compensated in transactions between independent parties in comparable situations. In addition, it would be of great importance also to determine in the legislation, how the concept of intangible property should be understood in the transfer pricing context.

In contrast to the Russian transfer pricing rules, the Finnish transfer pricing regulations have not restricted the applicability of the transfer pricing rules merely to certain types of controlled transactions. Hence, in addition to transfers of tangible assets, transfers of intangible assets generally fall within the scope of the national transfer pricing rules, which must be noted also in business restructurings. In particular, the OECD Transfer Pricing Guidelines' impact on the interpretation of the Finnish transfer pricing rules is significant, and therefore its guidance cannot be ignored, when national transfer pricing provisions are interpreted and applied in practice. This means that the concept of intangible asset must also be understood broadly under the Finnish transfer pricing rules.

Thus, transfers of, inter alia, intellectual property, know-how and other intangibles that may be separated from other possible asset transfers occurred in a business restructuring and that have commercial value, which would be compensated in transactions between independent parties, should primarily be compensated at arm's length also in business restructurings. However, it is not always self-evident, what other assets may be regarded as intangible assets subject to transfer pricing in this sense, and therefore the question must be explored on a case-by-case basis. Such intangibles do not need to be legally protected by particular national regulations or recorded on a company's

balance sheet, but a more decisive factor is whether unrelated parties would compensate transfers of such assets in corresponding conditions. Therefore, this approach also seems to be in line with the arm's length principle.

Similarly, pursuant to the U.S. regulations, apart from transfers of tangible assets, transfers of intangibles fall in general within the scope of the application of the arm's length principle. If a business restructuring involves transfers of intangible property expressly listed in Section 936(h)(3)(B) of the IRC and the related Treasury Regulations, such transfers will primarily fall within the scope of application of the U.S. transfer pricing rules. Such intangible properties include, among other things, the aforesaid intellectual properties and know-how, but also other assets that can be regarded as "other similar items" in accordance with the Treasury Regulations. Hence, it should be diligently examined in business restructurings on a transaction-by-transaction basis whether such "other similar [intangible] items" are transferred between related parties and especially whether independent parties would compensate transfers of such assets in similar circumstances.<sup>1005</sup>

Although intangible assets generally fall within the scope of the Finnish and U.S. transfer pricing rules, the broad concept of intangible property in transfer pricing is not entirely clear and straightforward in Finland and the USA. Consequently, the question of to what extent intangibles fall within the scope of the transfer pricing rules in business restructurings may cause interpretive problems in cases where it is not self-evident whether certain items or assets should be regarded as intangible assets and thus taken into account in the transfer pricing analysis of a business restructuring. As this kind of unclarity is against the aim of the arm's length principle, it should be considered whether such ambiguity could be addressed somehow in the national sources of transfer pricing to improve the certainty of the transfer pricing treatment of such (intangible) items. However, as in the current situation, the determination of all asset types falling within the scope of the concept of intangible assets is likely to be impossible, the existing transfer pricing rules are largely efficient in terms of the arm's length principle. In order to improve the compliance with the arm's length principle, the current rules could be amended *de lege ferenda* to address the aforementioned ambiguous

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<sup>1005</sup> However, the concept of "other similar items" under U.S. law may prove to be troublesome in certain cases, as it can be seen from the question with respect to transfer pricing of goodwill and going concern value. Therefore, although the above-mentioned approach (examination of whether independent parties would compensate transfers of such intangible assets) can be applied in the USA to a great extent, it cannot currently be applied unconditionally, and there exist *de lege ferenda* need for clarifying amendments to the existing law at least in terms of controlled transfers of goodwill and going concern value.

situations, only if certain measures could be found, without unnecessarily limiting the scope of the concept of intangible assets.

In addition to the above stated, certain intangible assets that are not separable, i.e. are not capable of being separated from other assets or an entity, may also be objects of transfer pricing in business restructurings pursuant to Finnish and U.S. law. Such intangibles should be considered to fall within the scope of the Finnish and U.S. transfer pricing rules, at least as a starting point, if they have economic value that would be compensated in transactions between independent parties. Especially the discussed goodwill and going concern value are these kinds of assets, which clearly have commercial value that would be compensated between unrelated parties but which also cannot be transferred separately from a complex of assets/business unit. Although, to some extent, there still exists unclarity as regards whether transfers of goodwill/going concern value can be treated as intangible property for the purpose of Section 482 of the IRC and corresponding Treasury Regulations, the newest regulations can be interpreted to allow such a conclusion.<sup>1006</sup>

Transfers of the aforementioned kind of intangibles may become objects of transfer pricing in the business restructuring context as part of a going concern. This is due to the fact that business restructurings may — and should — be regarded as transfers of a going concern for transfer pricing purposes pursuant to the Finnish and U.S. rules, when interrelated assets, functions and risks together form a functioning business unit that is transferred in the course of a restructuring, and the aggregation of such transactions would lead to the best result from the perspective of the arm's length principle. As previously discussed, in such cases, the assets/something of value belonging to such a business unit do not need to be separated from each other and correspondingly valued separately, as the business restructuring will be examined on an aggregate basis and an arm's length compensation would be determined only for the transferred going concern.

Apart from that it may at times be required to consider a business restructuring as a transfer of a going concern in order to achieve the most reliable arm's length result, the Finnish and the U.S. transfer pricing regulations may also demand that an appropriate arm's length remuneration should be paid under certain circumstances for the premature termination or renegotiation of existing arrangements, and thus the current legal situation deviates from the Russian situation also in this regard. On the other hand, transfers of risks — and possible associated profit potential — may not as such be objects of transfer pricing in business restructurings also in Finland and the

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<sup>1006</sup> While in Finland, transfers of goodwill fall within the scope of the Finnish transfer pricing rules already on the basis of the OECD Transfer Pricing Guidelines.



USA, but the allocation of risks will affect the transfer pricing analysis of business restructuring transactions through the functional and risk analyses. In this respect, all the three target countries conform to each other.

Overall, when the applicability of the transfer pricing rules is considered, business restructurings fall more effectively within the scope of application of the national transfer pricing rules and regulations in Finland and the USA than in Russia. Although certain partial issues still remain ambiguous (in particular, the transfer pricing treatment of goodwill and going concern value in the USA), the assets/something of value that are typically transferred in business restructurings fall greatly within the scope of the national transfer pricing rules of Finland and the USA. Consequently, the compliance with the arm's length principle is thus required and followed effectively in business restructurings. If independent parties would compensate certain transfers of assets/something of value or would remunerate the premature terminations of agreements in comparable circumstances, such transfers or terminations are also subject to transfer pricing in business restructurings between related parties and should ultimately be compensated at arm's length.

The difference between the current situations in Finland and the USA, on the one hand, and the situation in Russia, on the other hand, can primarily be explained with reference to the different hierarchy of legal sources and judicial systems. As discussed, the OECD Transfer Pricing Guidelines' impact on the interpretation of the Finnish transfer pricing rules is significant, and therefore its extensive guidance cannot be ignored, when national provisions and specifically the arm's length principle are applied in practice. Also other sources may be used in the interpretation of the legislated transfer pricing rules in the above-mentioned sense more extensively in Finland than in Russia. Similarly, the administrative sources — especially the Treasury Regulations — interpret the IRC's narrow provisions almost exhaustively, and they must be followed in practice by the IRS and taxpayers. The USA also has a long tradition in transfer pricing and is considered as one of the pioneer countries in terms of developing transfer pricing law. Therefore, it is not a surprise that U.S. tax law provides a wide range of regulations covering many aspects of different transfer pricing phenomena, which also are helpful in analyzing business restructurings.

Russia, on the contrary, has fairly new tax legislation, and the Tax Code's newest transfer pricing provisions that came into force on 1 January 2012 are its first attempt to have transfer pricing rules similar to the Western practice. Although the provisions are extensive, they are not exhaustive, and peculiarities still exist in the above-discussed manner in comparison with, for instance, the OECD Transfer Pricing Guidelines. As other legal sources are basically of a clarifying and non-binding nature (except for the decisions of the highest courts that may be legally binding in practice), the current provisions

would thus need to be improved *de lege ferenda* to be more in line with the OECD Transfer Pricing Guidelines in terms of the compliance with the arm's length principle.

When the extent of the business restructuring has been determined in a given case — i.e. it has been identified, what assets/something of value subject to transfer pricing are separately transferred in the course of the restructuring or whether the restructuring may be regarded as a transfer of a going concern — another important and complex question arises: how to determine the arm's length compensations for such transfers occurring in the business restructuring? None of the target countries have legislated specifically on the determination of arm's length compensations in the business restructuring context. Therefore, as a starting point, the general transfer pricing methods regulated by the national sources and/or the OECD Transfer Pricing Guidelines should primarily be applied to transfers of something of value conducted in the business restructuring context. Except for business restructurings involving solely transfers of tangible assets, the determination of an arm's length compensation is a troublesome question.

All the target countries prefer the use of the CUP/CUT method in controlled transactions involving transfers of intangibles at least to some extent. Thus, the possible use of the CUP/CUT method must primarily be considered also in business restructurings. As intangible assets usually have unique features and characteristics, it may be prove to be difficult to find comparables for the controlled transactions involving transfers of them. In such situations, the potential applicability of other regulated transfer pricing methods must be reviewed, especially if appropriate adjustments cannot be made to eliminate potential substantial differences between the controlled transaction and comparable uncontrolled transactions. Hence, it is likely that the applicability of the profit-based transfer pricing methods must quite often also be examined in business restructurings, if the restructurings involve transfers of intangibles.

Although the transactional net margin method/the comparable profits method may in general be applied to transactions involving intangibles under Russian, Finnish and U.S. law, the profit split method may be more efficient in connection with transactions involving purely transfers of intangible assets. It acknowledges the unique nature of intangibles and has been considered to be more suitable for direct valuation of intangibles; in addition, it does not rely on finding exact comparables. This has also been highlighted in the OECD's latest guidance in relation to transfer pricing of intangibles.<sup>1007</sup>

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<sup>1007</sup> In contrast to the Russian and the Finnish (OECD based) approaches, the comparable profits method may under the U.S. transfer pricing rules also be applied to the controlled transfers of rights in intangible

However, as the application of the profit split method usually requires that both parties of a related party transaction make unique and valuable contributions (e.g. use unique and valuable intangibles), it is unclear how the method should be applied to transactions involving purely transfers of intangibles. In such transactions only one party *de facto* makes unique contributions, i.e. transfers unique and valuable intangibles. The domestic rules have paid no attention to this question. Therefore, as the method has been considered to bring arm's length results also in transactions involving merely transfers of intangibles, if the CUP/CUT method may not be applied, it should be clarified in the domestic transfer pricing rules *de lege ferenda*, how the method should be applied particularly in such circumstances.

Furthermore, the aforementioned regulated transfer pricing methods may not always provide sufficient tools for determining arm's length compensations for intercompany transfers of intangible assets, for instance, due to reliable comparable uncontrolled transactions not being able to be found for the related party transaction in question, or the regulated transfer methods not being otherwise suitable at all in a given case.

Fortunately, all the target countries allow taxpayers to use also other valuation methods and techniques than specifically regulated transfer pricing methods, provided that such methods bring the most reliable arm's length results in such situations. Of great importance are especially the income based methods, such as the discounted cash flow method, as they are commonly used in practice in the direct valuation of intangibles in transactions between independent parties, and therefore they will more likely provide a more reliable arm's length result in comparison with the regulated transfer pricing methods or other unspecified methods (cost and market based methods). Such an approach is consequently consistent with the arm's length principle. As related parties would in such cases follow the same valuation principles that would be used by independent parties in comparable circumstances, the factors relating to the valuation and pricing of the transaction and the intangible in question are thus taken into account in a similar manner as it would be taken by unrelated parties.

However, the domestic transfer pricing rules as well as the OECD Transfer Pricing Guidelines seem to lack content in terms of applying such unspecified methods in practice. Although the Russian Tax Code contains a mention of the possibility of using such methods, the provisions basically refer to a non-taxation related act, and more detailed provisions of the types of the methods

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property in certain circumstances, which leads to that the applicability of both profit-based transfer pricing methods should always be considered in cross-border business restructurings under U.S. tax law.

are only covered by particular administrative regulations. While the OECD's guidance on the regulated transfer pricing methods may be considered sufficient for the purpose of following it as such in practice in Finland, the guidance on the application of other valuation techniques is very limited. The OECD Transfer Pricing Guidelines mention only income based methods as an example of such valuation techniques that could be considered in the valuation of intangibles in related party transactions.

As a consequence, the guidelines do not provide necessary tools for applying non-specified methods in practice. Similarly, although the Treasury Regulations interpreting Section 482 of the IRC accept explicitly the use of unspecified methods, they have not discussed the types of methods that could be regarded as unspecified methods at all. This may cause unnecessary uncertainty from the point of view of the arm's length principle, taking into consideration that the Treasury Regulations usually aim to address all topical questions of transfer pricing.

Hence, there are certain needs for amending the existing Russian, Finnish and U.S. transfer pricing rules *de lege ferenda*. The applicability of the aforementioned valuation techniques to the determination of transfer prices for transfers of intangibles should be regulated in a clear manner, providing detailed guidance on the application of such methods in practice. It must also be observed that while such valuation techniques may be used in corporate finance to determine the fair value of intangible properties or assets generally, the fair value standard and the arm's length standard are ultimately distinct valuation standards.<sup>1008</sup> Therefore, such principal differences should be taken into account, when other valuation methods than the regulated transfer pricing methods are applied in the transfer pricing context. If certain modifications should be made to such methods before applying them in the determination of arm's length compensations, this should also be dealt with directly in the domestic transfer pricing rules for the purpose of ensuring the efficient compliance with the arm's length principle.

Furthermore, it must also be observed that the application of such valuation techniques is not, in the end, an easy task. For instance, the income based methods require the prediction of future (net) profits, cash flows or other economic benefits the intangible asset in question may generate during its lifetime. If the prediction is done in an unreliable manner or the value is discounted to the present value by using an inaccurate discount rate, the end result (i.e. the determined value for the transferred intangible asset) may be inconsistent with the arm's length principle.

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<sup>1008</sup> See Wittendorff 2010b, pp. 325–326.

Another — even more complex — valuation issue arises from transfers of a going concern in the business restructuring context. As there are no particular provisions in Finnish and U.S. tax law as regards the determination of an arm's length remuneration for transfers of a functioning business unit, the application of the regulated transfer pricing methods — especially the CUP/CUT method — must primarily be considered in this connection. However, the use of the traditional transfer pricing methods may be difficult or even provide unreliable results in such situations, as the valuation of the transfer of a going concern should reflect all the valuable features and elements that would be compensated between unrelated parties in comparable circumstances. Also, it is likely that independent parties would use other kinds of methods than methods similar to the regulated transfer pricing methods.

On the other hand, both Finnish and U.S. tax law regulations and administrative sources contain guidance, which can be helpful in determining the arm's length compensation for a transfer of a going concern. Especially the income based methods, in particular the discounted cash flow method and its variations, have been widely approved and considered reliable and appropriate methods in determining the value for a going concern. They are not, inter alia, dependent on finding sufficient comparables. As these kinds of valuation techniques are also generally applied in practice by independent parties in business valuation, they will likely provide the best results in terms of the arm's length principle also in transactions between related parties.

Nevertheless, while both the OECD and Finnish transfer pricing sources refer in general to valuation techniques that independent parties would apply in comparable circumstances, i.e. in business acquisitions, they have not regulated such methods and the application thereof in detail. For instance, although both sources have expressly mentioned the possibility of using the discounted cash flow method in transfer pricing of transfers of a going concern, more detailed guidance on its use in the transfer pricing context is missing. Similarly, in the USA, the income method used specifically in cost sharing arrangements may, by expansive interpretation allowed by the IRS, be used in determining the arm's length value for transfers of a going concern. As the applicability of the method to business restructurings is based on the broad interpretation of the Treasury Regulations, detailed guidance on the application of the method to controlled transfers of a going concern in the business restructuring context is lacking. The current approaches in Finland and the USA may thus cause unnecessary uncertainty for the compliance with the arm's length principle. Hence, for the sake of clarity and transparency, the use of such methods — in particular, the discounted cash flow/income method — should be regulated *de lege ferenda* in the domestic transfer pricing rules in a concrete and detailed manner, paying attention also to potential issues that may arise in the business restructuring context. As with transfers of intangibles, if certain modifications should be made to such valuation

techniques before applying them in the transfer pricing context, this should also be dealt with directly in the transfer pricing rules for the purpose of ensuring the efficient compliance with the arm's length principle.

Nonetheless, the application of such methods to business restructurings is not an easy and straightforward task, as it often involves the projection of future income streams/cash flows and the determination of an appropriate discount rate. Therefore, similar to the valuation techniques used in the determination of an arm's length compensations for transfers of intangibles, the choice of the valuation method as well as all the parameters and figures related to its application must be chosen diligently in order to achieve a result consistent with the arm's length principle.

Contrary to the Russian transfer pricing rules, also the premature termination or renegotiation of an existing arrangement in connection with a business restructuring may be subject to transfer pricing in Finland and the USA. The arm's length compensation in case of premature terminations or renegotiations of existing agreements is determined to a great degree in a similar manner under both U.S. and Finnish law; the question of whether a remuneration should be paid for the termination of an existing commercial agreement should primarily be examined from the contractual terms of the specific agreement itself by comparing such terms to contractual terms used commonly by independent parties in similar situations (e.g. the field of business). National provisions and principles — such as, the principle of expectation interest under U.S. law and the positive interest under Finnish law — may serve as a guidance and should primarily be applied, if independent parties would be entitled to a compensation in accordance with such provisions and principles in similar circumstances. Nonetheless, as the current approach in the USA is broadly based on the interpretation of the arm's length standard, for the sake of clarity, the Treasury Regulations could *de lege ferenda* have general regulations highlighting the importance of reviewing terminations and renegotiations of existing agreements in the transfer pricing analysis of related party transactions comprising general references to commercial law and other sources of law potentially regulating indemnification rights in this connection.

As previously discussed, several uncertainty factors relate to the transfer pricing of business restructurings. It is not entirely clear, inter alia, to what extent transfers of intangible assets fall within the scope of application of the national transfer pricing regulations, what the most appropriate transfer pricing method (regulated or other valuation technique) in a given case is, and how to apply the chosen method in practice (comprising of but not limited to the choice of the correct comparables, figures and parameters). In particular, the determination of arm's length compensations for transfers of intangibles and a going concern is a difficult task.

Russia has been planning to join the OECD already for several years. When — and if — it finally becomes a member of the OECD, it will be in a similar position as Finland, the USA and other OECD member states; the national authorities and courts could be more willing to follow the OECD Transfer Pricing Guidelines at least to some extent in practice, although the guidance is not binding upon the member states. Furthermore, already in 2013, it has been stated that the OECD's BEPS Project may possibly bring amendments to the Russian transfer pricing provisions, especially by defining more precisely the intellectual property rights/intangibles falling within the scope of transfer pricing rules.<sup>1009</sup>

Although this has not happened yet, it is expected that sooner or later the Russian government and the Minfin will react to the prevailing ambiguity of the transfer pricing rules particularly in terms of transfers of intangibles. As the current situation concerning the transfer pricing aspects of business restructurings in Russia is somewhat unclear, and taking into account the overall eagerness of tax authorities to intervene in transfer pricing of transactions between related parties, one possible solution is to take advantage of APAs, which can be concluded between taxpayers and authorities before executing certain transactions in the course of business restructurings.

The conclusion of APAs may definitely bring benefits to taxpayers — the most important being the fact that once an APA has been concluded, the tax authorities must follow it. Nonetheless, the use of APAs is not uncomplicated in Russia, and they may not bring solutions in all cases. This is because only the so-called large taxpayers may conclude APAs in Russia, the state duty can be considered high and — most importantly — the use of bilateral/multilateral APAs is not yet possible. As the unilateral APAs are not binding on foreign tax authorities in a similar manner as the multilateral APAs, they may not currently be used effectively in cross-border business restructurings. Quite the contrary, the current legal situation in Finland and the USA enables the conclusion of both unilateral and bilateral/multilateral APAs, and therefore APAs may be used as an effective tool to eliminate at least some uncertainties and ambiguities related to the transfer pricing issues arising out of business restructurings, depending on the circumstances of the restructuring.

In addition to APAs, especially the compliance with the general transfer pricing documentation and reporting requirements may enable taxpayers to tackle some uncertainty factors in relation to transfer pricing in the business restructuring context. Notwithstanding that there might be slight differences between the current documentation and reporting requirements of Russia,

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<sup>1009</sup> Stroykova 2013, p. 11.

Finland and the USA, they aim to serve the same purpose: the examination and verification of whether the pricing and/or other terms and conditions of related party transactions are arm's length. By documenting related party transactions in a comprehensive and thorough way, a taxpayer may demonstrate that the transfer prices used in business restructuring transactions and other transfer pricing issues related thereto (e.g. the choice of the transfer pricing methods) are in line with the arm's length principle, and eventually the taxpayer may increase the chances of avoiding disputes and conflicts with tax authorities

Moreover, taxpayers' self-initiated transfer pricing adjustments may lead to potential transfer pricing disputes with tax authorities being avoided, for example, in situations where a taxpayer notices the failure of applying arm's length prices in its controlled transactions before filing the annual income tax return. As they can in principle be used only as post-transaction tools in Russia, Finland and the USA, in comparison with APA processes and/or maintaining a comprehensive transfer pricing documentation, they cannot be used as effectively to eliminate uncertainties arising from transfer pricing issues in business restructurings.

Apart from analyzing whether related parties have complied with the arm's length principle in the course of business restructurings, the anti-avoidance rules prohibiting unjustified tax benefits must be borne in mind in the decision-making with regard to business restructurings. It may ultimately be reasonable to demonstrate that the group is not seeking to reduce its payable income taxes or avoid taxes contrary to the legislator's intention. This may — or is required to — be done by showing the economic- and business-related purposes and reasons behind the business restructuring, as previously discussed.

In particular, this is of great importance at present in Russia, as transfers of intangibles do not generally fall within the scope of the Russian transfer pricing regulations. If, for example, intangible assets that are not considered intellectual properties are transferred between related parties in the course of a business restructuring, the arm's length principle does not necessarily need to be applied pursuant to the current transfer pricing rules. However, this does not mean that such assets could be transferred considerably overpriced or underpriced, as it is very likely that the FTS would be willing to challenge such transactions by invoking the principle of unjustified tax benefits. Hence, the anti-avoidance rules and principles must also be followed in business restructurings. When a taxpayer successfully shows reasonable justifications for the business restructuring transactions, e.g. in the transfer pricing documentation, the likelihood of potential conflicts with tax authorities may be reduced.



Such an approach must also be followed in Finland and the USA. Specifically in Finland, the compliance with the anti-tax avoidance rules is currently a topical question, as the Council of the EU published quite recently, on 12 July 2016, a directive on laying down rules against tax avoidance practices that directly affect the functioning of the internal market.<sup>1010</sup> Pursuant to the directive, the EU member states must take certain measures against tax avoidance, comprising of, inter alia, adopting tax law provisions with regard to exit taxation and anti-abuse in general. Such provisions must be applied already as of 1 January 2019. It should be observed that the directive was adopted as a consequence of the OECD's BEPS Project in order to implement within the EU, more efficiently and with a certain degree of uniformity, rules for preventing base erosion and profit shifting risks introduced by the OECD.

## **6.2 OECD'S PRESENT APPROACH AND ROLE IN DEVELOPING INTERNATIONAL TRANSFER PRICING STANDARD**

As previously mentioned, the OECD finished its principal work in relation to the BEPS Project at the end of 2015, resulting in the new consolidated version of the OECD Transfer Pricing Guidelines being published in 2017. Although the OECD did not revisit the actual guidance provided in Chapter IX with regard to transfer pricing of business restructurings, conforming amendments to Chapter IX were necessary in order to avoid inconsistencies between the other revised chapters and Chapter IX. Nevertheless, there still exist uncertainties and ambiguity in certain transfer pricing questions arising from business restructurings, which may lead to that the arm's length principle cannot always be complied with efficiently.

As OECD's guidance covers the typical objects of transfer pricing in business restructurings and enables business restructurings to be regarded as transfers of a going concern for the purpose of achieving the best arm's length result, it is principally consistent with the arm's length principle. Furthermore, the OECD's approach seems to be in line with the arm's length principle, when the determination of arm's length compensations for transfers of something of value in the business restructuring context is preliminarily examined. The regulated transfer pricing methods as well as other valuation techniques may be used in determining arm's length compensations for the purpose of achieving the best arm's length result.

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<sup>1010</sup> Council Directive (EU) 2016/1164 of 12 July 2016 on laying down rules against tax avoidance practices that directly affect the functioning of the internal market.

In particular, the use of the broad concept of intangible assets in the OECD Transfer Pricing Guidelines makes it possible that all such intangible assets that would be compensated in transactions between independent parties should correspondingly fall within the scope of application of domestic transfer pricing rules — and thus be subject to the arm's length principle — in business restructurings. In the current situation, as is it extremely unlikely that all intangible asset types could be defined exhaustively in domestic transfer pricing rules, the mentioned approach brought good results in terms of the arm's length principle in Finland. However, while such an approach seems to be the best option to achieve an arm's length result in the current legal situation in Finland, it is less acceptable to have such unclarity in an international standard that would be followed broadly by the OECD member states and even by non-member states.<sup>1011</sup>

As the concept is left open to interpretation, the uncertainty in relation to transfer pricing of intangible assets increases in cases where it is unclear whether an item should be regarded as an intangible asset and, if so, whether a transfer thereof would be compensated in transactions between independent parties. This makes the compliance with the arm's length principle more uncertain and unpredictable — which is against the aim of the principle. A vague interpretation may benefit tax authorities, entitling them to interpret the concept for their benefit. Moreover, the risk of double taxation increases.<sup>1012</sup> The question of how to define intangibles in a more concrete manner to avoid the aforementioned uncertainty factors and issues, covering nevertheless all potential items of value that would be compensated in transactions between independent parties, remains to be answered in the guidelines.

Furthermore, the determination of arm's length compensations for transfers of intangibles is not dealt with in a sufficient manner. As the profit split method primarily requires that both parties to a related party transaction make unique and valuable contributions (e.g. use unique and valuable intangibles), it is unclear how the method should be applied to transactions involving solely transfers of intangibles or rights in intangibles. As in business restructurings, usually only one party makes unique contributions, i.e. transfers unique intangibles, it should be clarified in the guidelines, how the method should be applied particularly in such circumstances. Second, although the guidelines regard other valuation techniques as useful tools for the determination of arm's length compensations where reliable comparables

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<sup>1011</sup> See about the OECD's remarkability in practice in e.g. Lubic – Gelin – Ossard-Quintaine 2014, pp. 70–71.

<sup>1012</sup> Markham 2015, pp. 684, 686–687.

cannot be found for the controlled transfer of intangible assets,<sup>1013</sup> and in this sense follow the arm's length principle, the regulated guidance lacks the necessary content for their successful application in practice. The valuation techniques must be used in a manner that is in line with the arm's length principle and other guidance of the OECD Transfer Pricing Guidelines,<sup>1014</sup> but no clarifying guidance for the satisfaction of this requirement is provided.

The guidelines also state that the valuation assumptions used in accounting may lead to a result that is not acceptable in transfer pricing,<sup>1015</sup> resulting in that the special circumstances and nature of transfer pricing need to be taken into consideration in the application of such methods. However, the content of the guidelines in this regard is vague and insufficient, which leads to it being uncertain when and how the arm's length result, that is consistent with the principles of the guidelines, may be achieved by using such valuation techniques.

In addition, the OECD provides insufficient guidance on conditions on which business restructurings should be regarded as transfers of a going concern for transfer pricing purposes. Although the OECD defines the concept in a definite manner, it does not regulate clearly when the examination of contemporaneous transfers of assets, risks and functions should be analyzed on an aggregate basis. In addition, the guidelines do not currently take a clear stand on whether it prefers the approach based on the examination of contemporaneous transfers of assets/something of value as a whole over the approach based on separate analyses of related party transaction occurring in a business restructuring.

Furthermore, when the arm's length valuation needs to be done on an aggregate basis, the guidelines have not regulated valuation techniques and the application thereof in a sufficient manner. The OECD Transfer Pricing Guidelines refer in general to valuation techniques that independent parties would apply in comparable circumstances, i.e. in acquisition deals, as well as to the potential use of the unspecified methods used in the valuation of intangibles. Regardless of that this approach allows the use of income based methods, in particular the discounted cash flow method and its variations, the application of such methods in the transfer pricing context remains ambiguous. Hence, similarly to transfers of intangibles, the OECD's guidance is too vague and does not provide concrete tools for determining arm's length compensations for transfers of a going concern in a predictable and reliable

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<sup>1013</sup> OECD Transfer Pricing Guidelines, 6.153.

<sup>1014</sup> OECD Transfer Pricing Guidelines, 6.154.

<sup>1015</sup> OECD Transfer Pricing Guidelines, 6.155.

manner. The lacking guidance in this respect is, ultimately, contrary to the aims of the arm's length principle.

Hence, on the aforementioned grounds, the OECD Transfer Pricing Guidelines cannot, in their present form, be adopted effectively to domestic transfer pricing legislation and regulations, when transfer pricing aspects of business restructurings are considered. However, although the OECD already finished its principal work in relation to the BEPS Project, it has nevertheless continued publishing further guidance as regards certain specific questions in 2017 and is expected to continue publishing such in the forthcoming years. For instance, the guidance in relation to the use of the profit split method is currently being amended in the discussed manner.<sup>1016</sup> It would be important that the OECD could continue publishing further guidance to address the prevailing uncertainties in transfer pricing in general and particularly to address the concerns with regard to transfers of intangibles and a going concern.

In the current situation, one solution to tackle the challenges in relation to cross-border transfer pricing questions, such as business restructurings, could be the universal implementation of the OECD's guidance by national legislators and authorities, provided that the above-mentioned concerns are sufficiently addressed by introducing amendments and/or updates to the guidelines. The role of the OECD Transfer Pricing Guidelines in developing international tax law cannot be disregarded. The OECD Transfer Pricing Guidelines generally offer a significant set of rules as regards transfer pricing, and the OECD is continuously developing and adopting new guidance. If the OECD's work would effectively, and in a consistent way, be followed globally and incorporated into national legislations or other legally binding national sources of countries (both OECD and non-OECD), the transfer pricing treatment of particular questions, or at least the rules and factors affecting the treatment thereof, could be assessed more effectively beforehand. Due to the fact that the guidelines are widely accepted, also countries that are not OECD member states follow to a great extent the guidelines when they enact domestic transfer pricing rules.<sup>1017</sup> In this connection, the OECD's BEPS Project provides a good example of the important work the OECD is doing to address new tax and transfer pricing questions arising from the changes in business life and new forms of business activities.

It should be noted that, due to differences in the judicial systems, hierarchy of laws and/or other peculiarities in the national legal systems, international guidance — such as the OECD Transfer Pricing Guidelines — may not always be applied and followed uniformly in different countries. Taxation is in the end

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<sup>1016</sup> See e.g. OECD Public Discussion Draft on Revised Guidance on Profit Splits.

<sup>1017</sup> Calderón 2007, pp. 4–5; Lubic – Gelin – Ossard-Quintaine 2014, pp. 70–71.

strongly a national issue. Therefore, in addition to providing general guidance for the application of transfer pricing principles and rules to specific questions globally, it is important to provide a framework and tools for the co-operation of national tax authorities to resolve cross-border questions. In the transfer pricing context, of great importance is also to provide sufficient regulations allowing the conclusion of bilateral and/or multilateral APAs. As seen above, such APAs achieve the best result in terms of resolving complex and ambiguous cross-border transfer pricing questions in a legally binding way before entering into transactions. As the OECD Transfer Pricing Guidelines have provided specific guidance and tools for adopting domestic transfer pricing rules for concluding bilateral/multilateral APAs, it is reasonable to follow the guidelines also in this respect.<sup>1018</sup>

### **6.3 ARM'S LENGTH PRINCIPLE'S FUTURE?**

As evidenced by this study, the compliance with the arm's length principle may not be achieved easily and efficiently in certain transfer pricing questions. Business restructurings form a good example of complex cross-border tax questions, where it is not self-evident that the arm's length result can be achieved in a reliable manner — or at all. On the other hand, not every aspect and feature of transfer pricing can be covered by domestic or international transfer pricing rules or standards. For example, although the OECD has in recent years paid a great deal of attention to various transfer pricing questions, the compliance with the arm's length principle is not realized efficiently even in its newest guidance. Hence, it can even be considered whether the best results from the point of view of the arm's length principle may be achieved by constantly amending the existing transfer pricing rules.

In the legal literature, it has even been considered that the OECD's latest amendments, in particular in relation to intangibles, lead to inconsistency with the arm's length principle. The OECD's broad concept of intangible assets introduced by the BEPS Project has been regarded to cause uncertainty to the transfer pricing of intangibles, instead of limiting it.<sup>1019</sup> It has been stated that “progress on the revised guidance on the definition of intangibles is being prevented by the inability of transfer pricing to provide an anti-avoidance or protectionist tool within the confines of the arm's length principle.”<sup>1020</sup> Furthermore, it has been viewed that the increased use of intangibles has

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<sup>1018</sup> See Chapter IV of the OECD Transfer Pricing Guidelines. See also OECD Transfer Pricing Guidelines, Annex I and II to Chapter IV. The former provides for tax authorities' use specific memoranda that can be used in drafting bilateral agreements. See also BEPS Actions 14–15.

<sup>1019</sup> Markham 2015, p. 687.

<sup>1020</sup> This view of John Henshall was expressed in Markham 2015, p. 686.

decreased the role of transfer pricing and the arm's length principle as anti-avoidance tools, mainly due to their high reliance of comparables. This may also lead to that the arm's length principle may not be used to counter tax avoidance, but it may even make tax avoidance easier.<sup>1021</sup> As this study reveals, certain problems in relation to the compliance with the arm's length principle in the transfer pricing of intangibles — as well as a going concern — are also present in business restructurings. From this perspective, the arm's length principle is imperfectly followed.

Consequently, a question arises whether there exist plausible alternatives to the arm's length principle and transfer pricing in the current situation. As this question is beyond the scope of this research, only some preliminary remarks on potential alternatives, without prioritizing one over another and providing an exhaustive analysis, are discussed briefly in the following. Furthermore, as this question ultimately requires a more elaborate study, *future research could be suggested in this connection on whether certain alternatives could replace the arm's length principle in transfer pricing of business restructurings and other complex transactions involving transfers of intangibles in a post-BEPS world*. This could comprise a comparison between the arm's length principle as regulated in the OECD's latest work and the possible alternative(s) suggested to it in the current situation.<sup>1022</sup>

Global formulary apportionment has been brought out most often when alternatives to the arm's length principle have been discussed. Under global formulary apportionment, a multinational enterprise allocates the consolidated profits of the group to local companies operating in different jurisdictions by using a specific formula.<sup>1023</sup> One of the advantages of the global formulary apportionment is that no comparable uncontrolled transactions need to be found for intangibles, which is usually an extremely difficult task in transfer pricing. This is because no related party transactions are reviewed in this approach for the purpose of income allocation. Hence, it eliminates the majority of the problems arising out of the arm's length principle.<sup>1024</sup> The OECD Transfer Pricing Guidelines acknowledges the existence of the concept of global formulary apportionment. However, the guidelines itself do not consider it as a realistic alternative to the arm's length principle. The main concern is that the implementation of the system based on global formulary apportionment in a way that the risk of double taxation is

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<sup>1021</sup> T'ng 2016, pp. 421–422.

<sup>1022</sup> Although the use of the arm's length principle and potential alternatives thereto especially in the context of transfer pricing of intangibles have often been discussed in the legal literature, no comprehensive studies have yet been conducted on this topic in a post-BEPS situation.

<sup>1023</sup> Markham 2005, p. 134.

<sup>1024</sup> Markham 2005, pp. 134–136.

prevented and single taxation is ensured is, in the end, particularly difficult. Also, global formulary apportionment is considered infeasible and costly to maintain.<sup>1025</sup>

Another alternative to transfer pricing and the arm's length principle that is, at least to some extent, based on the global formulary apportionment is the EU's common consolidated corporate tax base (hereinafter the "CCCTB") initiative. In October 2016, the Commission published two directive proposals with the aim of establishing the CCCTB within the EU.<sup>1026</sup> In this two-step approach, the first directive would introduce rules for determining a common corporate tax base in the EU's internal market, while the second directive would set out certain rules for consolidation of the taxable profits of a group and, more importantly, allocating the consolidated taxable profits to the group companies pursuant to a specific apportionment formula.<sup>1027</sup> The advantages of this initiative are, *inter alia*, that the reliance on comparables is removed and the transfer pricing manipulation is thus also eliminated. On the other hand, the project has been criticized, for example, for excluding the intangibles from the apportionment formula, which may ultimately decrease the accuracy of the allocation of the consolidated taxable income.<sup>1028</sup>

One further solution to the current situation concerning the arm's length principle could also be the combination of the approaches of the arm's length principle and the formulary apportionment, i.e. adopting a hybrid regime. It has been proposed that the formulary apportionment could be used in the context of the arm's length principle, when the transfer pricing methods could not be used due to the lack of comparables. In this way, the arm's length principle would not be replaced in its entirety, but it would be supplemented by the formulary apportionment, for instance, in transactions involving transfers of non-routine intangibles.<sup>1029</sup> Another advantage would be that no fundamental changes would be required in the basic structure of the existing international tax regime.<sup>1030</sup>

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<sup>1025</sup> OECD Transfer Pricing Guidelines, 1.19, 1.21–1.22, 1.24 and 1.27. About other concerns, see OECD Transfer Pricing Guidelines, 1.23–1.31. See more detailed analysis of the global formulary apportionment in a pre-BEPS world in Markham 2005, pp. 133–157. See also Brauner 2008, pp. 159–164, where the formula based regime is regarded as the future of transfer pricing.

<sup>1026</sup> EU Commission Proposal for a Council Directive on a Common Corporate Tax Base, 25 October 2016 (COM (2016) 685 final) and EU Commission Proposal for a Council Directive on a Common Consolidated Corporate Tax Base (CCCTB), 25 October 2016 (COM (2016) 683 final).

<sup>1027</sup> *Ibid.*

<sup>1028</sup> T'ng 2016, pp. 423–425.

<sup>1029</sup> Avi-Yonah 2010, pp. 16–17; Markham 2005, p. 157.

<sup>1030</sup> Avi-Yonah – Benshalom 2011, p. 397.

Moreover, the stretching of the boundaries of the arm's length principle itself has been discussed as one option in this connection. In this approach, the arm's length principle should not be considered as a narrow and inflexible instrument, but it could be interpreted more broadly, allowing measures that are barely within the traditional boundaries of the arm's length principle. The arm's length principle could be considered as an evolving principle that is continuously developed to better reflect economic reality and circumstances, in which business activities are carried on.<sup>1031</sup> For instance, the profit split method has been regarded as one concrete example of situations where the boundaries of the arm's length principle have been broadened, as the application of the method does not rely on finding exact comparables and uses more internal data.<sup>1032</sup>

It has also been viewed that the arm's length principle has evolved from its origins, where it was understood as a pure legal fiction used to business income allocation between group companies, to reflect the economic reality of the transactions better. In this view, for instance, increasingly more attention in the transfer pricing analysis of transactions is paid to the commercial rationality of the transactions, instead of purely relying on the contractual arrangements as such. The BEPS Project has thus, in this sense, developed the arm's length principle further or provided a new interpretation of it.<sup>1033</sup> When the principle is in this way considered a flexible and evolving instrument, it may in the current situation still be a solid and reliable transfer pricing standard, when compared to, for example, the global formulary apportionment.<sup>1034</sup>

On the other hand, when the scope of the arm's length principle is evolved and developed further, it may in some situations lead to the weakening of the principle. For instance, more advanced transfer pricing documentation and reporting requirements that entitle tax authorities to obtain information about intangibles, supply chains and value drivers may ultimately result in a formulary apportionment of income, if tax authorities make assumptions or misinterpretations on the basis of such information.<sup>1035</sup>

In contrast to the above mentioned, also more radical proposals have been suggested in the legal literature. For example, it has been proposed to adopt destination-based corporate tax regimes instead of the conventional source- or residence-based corporate tax regimes, as in the former, the arm's length

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<sup>1031</sup> Petruzzi 2016, p. 27; Koomen 2015, p. 242.

<sup>1032</sup> Koomen 2015, pp. 242–243.

<sup>1033</sup> Petruzzi 2016, pp. 21–23 and 27–28; Heggmaier 2017, pp. 264–265.

<sup>1034</sup> Petruzzi 2016, pp. 28–30.

<sup>1035</sup> Kaeser – Bremer 2016, pp. 201–202.



principle's general inability to solve problems in relation to profit allocation in some cases is avoided.<sup>1036</sup> However, as the arm's length principle has, as an international standard, largely been embedded to the existing double treaties, making such deviations from the principle may be an enormous and time-consuming task.<sup>1037</sup>

All in all, the potential alternatives to the arm's length principle may, in the aforementioned manner, be discussed from very different points of view. The above mentioned provides examples of different approaches already discussed to some extent in the legal literature, and the purpose was not to provide an all-embracing description of all the possible options. As, in the current legal state, there remain unsolved issues from the perspective of the arm's length principle in general and particularly in the transfer pricing of transfers involving intangibles and a going concern, further research in this context is needed.

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<sup>1036</sup> T'ng 2016, pp. 431–433.

<sup>1037</sup> Petruzzi 2016, p. 28.